S. HRG. 99-271

MONEY LAUNDERING IN PUERTO RICO

HEARING

BEFORE THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

JULY 25, 1985

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CONTENTS

Opening statements: Page
- Senator Roth ... 1
- Senator Rudman ... 8
- Senator Nunn ... 18

WITNESSES

THURSDAY, JULY 25, 1985

Charles Blau, Associate Deputy Attorney General, Department of Justice ... 9

Charles Morley, chief investigator, Permanent Subcommittee on Investigations ... 39

William J. Schilling, Director, Office of Examinations and Supervision, Federal Home Loan Bank Board, accompanied by Vincent Cerreta, former Acting Director, Federal Home Loan Bank Board, New York Regional Office, and Frank Nelson, Field Manager, Federal Home Loan Bank Board, New York Regional Office ... 64

Antonio J. Munoz, chairman and chief executive officer, Banco Financiero de Puerto Rico as given through an interpreter, Irene King, and Jose Dumont, chief executive officer, Caribbean Federal Savings Bank ... 109

Hector Ledesma, president, Puerto Rico Bankers Association and chief executive officer, Banco Popular de Puerto Rico, and Mariano J. Mier, president, Puerto Rico Savings and Loan Association and president, First Federal Savings Bank ... 126

ALPHABETICAL LIST OF WITNESSES

Blau, Charles:
- Testimony ... 9
- Prepared statement ... 23

Cerreta, Vincent: Testimony ... 64

Dumont, Jose: Testimony ... 109

Ledesma, Hector:
- Testimony ... 126
- Prepared statement with an attachment ... 139

Mier, Mariano J.:
- Testimony ... 126
- Prepared statement with an attachment ... 156

Morley, Charles:
- Testimony ... 39
- Daily amount of manager's checks purchased by Rodal Magazines Distributors, Inc., on days reviewed ... 54
- Prepared statement ... 58

Munoz, Antonio J.:
- Testimony ... 109
- Prepared statement ... 116

Nelson, Frank: Testimony ... 64

Schilling, William J.:
- Testimony ... 64
- Prepared statement with attachments ... 81

EXHIBITS

	Introduced on page	Appears on page
1. FHLBB examination data	3	4
2. Letter to Chairman Roth from Juan Acosto Alicea, Secretary of the Treasury of Puerto Rico	36	37
3. Large currency flows through Puerto Rican banks	39	40
4. Documents submitted by Mr. Morley during his testimony	43	44

MONEY LAUNDERING IN PUERTO RICO

THURSDAY, JULY 25, 1985

U.S. SENATE,
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The subcommittee met at 9:40 a.m., in room SD-342, Dirksen Senate Office Building, under authority of Senate Resolution 76, section 13, dated March 2, 1983, Hon. William V. Roth, Jr. (chairman of the subcommittee) presiding.

Members of the subcommittee present: Senator William V. Roth, Jr., Republican, Delaware; Senator Warren B. Rudman, Republican, New Hampshire; Senator Sam Nunn, Democrat, Georgia; and Senator Albert Gore, Democrat, Tennessee.

Members of the professional staff present: Daniel F. Rinzel, chief counsel; Eleanore J. Hill, chief counsel to the minority; Katherine Bidden, chief clerk; Charles Morley, chief investigator; Glenn Fry, investigator, Paul Barbadoro, staff counsel; Sarah Presgrave, executive assistant to the chief counsel of the majority; Charles Osolin, press secretary; Debby Kamans, Carla Martin, Colm Connelly, and Chris McAndrews, staff assistants.

[Senators present at the convening of the hearing: Senators Roth and Rudman.]

OPENING STATEMENT OF CHAIRMAN ROTH

Chairman ROTH. The subcommittee will please be in order.

The Permanent Subcommittee on Investigations has a longstanding tradition of investigating organized crime in America. In recent years, we have concentrated our attention on money laundering, a rapidly spreading and widely misunderstood tool of organized crime elements. We have had considerable success with this effort, such as the passage of our amendments to title 31 and the Foreign Evidence Act.

Nevertheless, it is very frustrating to find large pockets of noncompliance with the Bank Secrecy Act in the banking industry, too often minimal or nonexistent enforcement in the Government's bank regulatory apparatus. The Government continues to prosecute bankers, drug traffickers, and launderers. The committee has held hearings on it, and yet here we are once again confronted with what appears to be numerous examples of ignorance of the law, negligent disregard and criminal noncompliance with the provisions of the Bank Secrecy Act, this time in Puerto Rico.

On June 6, 1985, Federal agents raided 10 banks and bank branches and arrested 17 persons, most of them bank officials in one of the largest money laundering investigations in the United States. I want to congratulate the task force responsible for this action. The task force is, of course, made up of the Department of Justice, FBI, IRS, DEA, as well as others.

Upon learning about this problem, we immediately sent senior members of our staff to Puerto Rico to evaluate the situation and our objectives were quite specific. We wanted to determine the nature and scope of violations in Puerto Rico; we wanted to determine what possible set of circumstances could lead to so many bank employees violating the Bank Secrecy Act in one location; and we hoped to determine what could be done to prevent this type of noncompliance in the future in Puerto Rico and everywhere else. We will hear the results of these inquiries today.

Now the suggestion has been raised that all this dirty money in Puerto Rico is merely tax evasion money; that tax evasion is a kind of sport wherein hundreds of rich players buy bearer certificates of deposit under a phony name with the help of understanding bankers. We are told that nothing serious is going on and that we can rest assured that no one would accept drug money.

I would like to clear up that misconception right now. Bank employees who knowingly help people evade taxes are committing a crime. They are corrupt. The fact is that widespread corruption of employees in the banking industry is an open invitation to narcotics money laundering. And in the case of Puerto Rico, as is all too common elsewhere in the United States, the narcotics money launderers have arrived. It is up to all of us to run them out, and I just want to reemphasize that it is money laundering that enables the illicit drug industry to exist, and we are not going to be satisfied in this subcommittee until we end this kind of money laundering, for whatever reason.

Frankly, I find it incredible to hear that so many of the bearer certificates of deposit in Puerto Rico are held for tax evasion purposes. Does this mean that some elements of the financial institutions in Puerto Rico are built on a foundation of crime? Does this mean that lying, cheating, and corruption are tacitly accepted by certain elements of the banking community? These are very, very troubling questions.

And once again we have the ephemeral banking regulators flitting from one banking institution to another, oblivious to situations you would have to be blind to miss.

I will be very frank, I find it very hard to wonder what these regulators were doing, were doing back in 1982, 1983, 1984 when the FBI, the Justice Department and others were making an investigation. You know, sometimes I become concerned we pass new laws, create a new agency and we think we solve a problem. But too often nothing happens.

Bearer certificates of deposit are an excellent case in point. This may come as a surprise to the Federal Home Loan Bank Board, but failure to keep detailed identifying records with respect to certificates of deposit is a violation of the Bank Secrecy Act. Knowingly failing to do so is a crime. It took our investigators only a matter of minutes in several banks to find case after case of such violations. Some have had all the earmarks of criminal violations. Now the Federal Home Loan Bank Board regulators didn't catch these incredible violations because in most cases they apparently simply gave the Bank Secrecy Act check sheet to their appropriate bank officials to complete. The results were predictable.

It is instructive to note that in 1983, the Federal Home Loan Bank Board examined 2,185 savings and loans nationwide, including Puerto Rico, and found only two Bank Secrecy Act violations, whereas in the same year, the FDIC found 10 of the 11 Puerto Rican banks examined to be in some form of noncompliance with the act. I can give you a number of other illustrations.

At this point in the record I will insert that information and also my prepared statement.

[The information referred to was marked exhibit No. 1 and follows. Chairman Roth's prepared statement also follows:]

EXHIBIT NO. 1

MEMORANDUM

TO: Puerto Rico Money Laundering File
FROM: Colm Connolly
DATE: July 22, 1985
RE: FHLBB Examination Data

I. Statistical Summary of FHLBB Semiannual Examination Results as regards the Bank Secrecy Act

Date Report Filed with Treasury	Number of Institutions Examined	Number of Institutions in violation of BSA	Number of Reports received from Treasury of apparent violations	Number of Cases referred to Director (of OES)	Number of Cases referred to Treasury
3/12/80	1,806	7	0	0	0
8/28/80	1,736	7	0	0	0
2/18/81	1,490	7	0	0	0
8/5/81	1,622	4	1	0	0
2/19/82	1,542	3	0	0	0
9/15/82	1,531	7	0	0	0
2/23/83	1,352	4	2	0	0
8/19/83	1,131	2	0	0	0
2/9/84	1,054	0	0	0	0
8/9/84	959	0	1	0	0
2/21/85	947	0	1	0	0

II. Comparison of FHLBB and FDIC Examination Findings as regards Bank Secrecy Act violations

FHLBB

	1980	1981	1982	1983	1984
# of institutions examined	3543	3112	3073	2483	2013
# of institutions in violation	14	11	10	6	0
% found to be in violation	.39	.35	.33	.24	0

FDIC

	1980	1981	1982	1983	1984
# of institutions examined	6776	6655	5787	3608	2054
# of institutions in violation	497	988	1150	697	461
% found to be in violation	7	15	20	19	22

III. Totals for 1980 - 1984

FHLBB

# of Exams	14,224
# of violations	41
%	.00288

FDIC

# of Exams	24,880
# of violations	3,793
%	15

PREPARED STATEMENT OF CHAIRMAN ROTH

The Permanent Subcommittee on Investigations has a long-standing tradition of investigating organized crime in America. In recent years we have concentrated our attention on money laundering, a rapidly spreading and widely misunderstood tool of organized criminal elements. We have had some significant successes in this effort, such as the passage of our amendments to Title 31 and the Foreign Evidence Act.

Nonetheless, it is still frustrating to find large pockets of noncompliance with the Bank Secrecy Act in the banking industry, and minimal or nonexistent enforcement in the government's bank regulatory apparatus. The government continues to prosecute bankers, drug traffickers and launderers. We and other committees hold extensive hearings on the subject. The news media is full of stories of the devastating effect of the drug trade and money laundering—the glue that holds it together. And yet here we are once again, confronted with what appears to be numerous examples of ignorance of the law, negligent disregard and criminal noncompliance with the provisions of the Bank Secrecy Act; this time in Puerto Rico.

On June 6, 1985, Federal agents raided 10 banks and bank branches and arrested 17 persons, most of them bank officers, in one of the biggest money laundering investigations in U.S. history. We immediately sent senior members of our staff to Puerto Rico to evaluate the situation. Our objectives were quite specific: We wanted to determine the nature and scope of violations in Puerto Rico; we wanted to determine what possible set of circumstances could lead to so many bank employees violating the Bank Secrecy Act in one location; and we hoped to determine what could be done to prevent this type of noncompliance in the future—in Puerto Rico or anywhere else. We will hear the results of these inquiries today.

Now the suggestion has been raised that all this dirty money in Puerto Rico is merely tax evasion money—that tax evasion is a kind of sport wherein hundreds of rich players buy bearer certificates of deposit under phony names, with the help of understanding bankers. We are told that nothing serious is going on and that we can rest assured that no one would accept drug money.

I would like to clear up any misconception right now. Bank employees who knowingly help people evade taxes are committing a crime. They are corrupt. The fact is that widespread corruption of employees in the banking industry is an open invitation to narcotics money launderers. And in the case of Puerto Rico, as is all too common elsewhere in the U.S., the narcotics money launderers have arrived. It is up to all of us to run them out.

Frankly, I find it incredible to hear it so widely ackowledged that many of the bearer certificates of deposit in Puerto Rico are held for tax evasion purposes. Does this mean that some elements of the financial institutions in Puerto Rico are built on a foundation of crime? Does this mean that lying, cheating and corruption are tacitly accepted by these elements in the banking community? These are very troubling questions.

And once again we have the ephemeral bank regulators flitting from one banking institution to another, oblivious to situations you would have to be blind to miss. Bearer certificates of deposit are an excellent case in point. This may come as a surprise to the Federal Home Loan Bank Board but failure to keep detailed identifying records with respect to certificates of deposit is a violation of the Bank Secrecy Act. Knowingly failing to do so is a crime. It took our investigators a matter of minutes in several banks to find case after case of such violations. Some had all the earmarks of criminal violations. The Home Loan Bank Board regulators didn't catch these incredible violations because in most cases they apparently simply give the Bank Secrecy Act check sheet to the appropriate bank officials to complete. The results were predictable.

It is instructive to note that in 1983 the Federal Home Loan Bank Board examined 2185 savings and loans nationwide, including Puerto Rico, and found 2 Bank Secrecy violations, whereas in the same year, the Federal Deposit Insurance Corporation found 10 of the 11 Puerto Rico banks examined to be in some form of noncompliance with the Act. In 1984, the Bank Board found zero violations out of 1,906 examinations nationwide. In Puerto Rico alone, the FDIC found 6 of the 7 banks examined in noncompliance. Now this either means that the savings and loans are models of compliance with the Act, or that the Board just is not doing its job. There is little question in our minds that the latter is the case: The Federal Home Loan Bank Board has consistently dropped the ball regarding enforcement of the Bank Secrecy Act. In the entire history of the Act, since its passage in 1970, the Board has referred a grand total of 2 financial institutions to the Treasury Department for civil penalties, none for criminal penalties. These figures are based on the Boards' own summaries, extracts of which I will introduce into the record. Apparently the Board and its examiners have no idea of the significance of the Acts' value in attacking organized criminal groups. They must not read the newspapers. Unfortunately, their negligence has allowed a totally intolerable situation to perpetuate itself for years to the great detriment of the financial institutions—and the citizens of Puerto Rico.

Now I want to make it clear that I do not believe the lack of enforcement by the Federal Home Loan Bank Board is the exclusive responsibility of the current leadership of the Board. The Board obviously has many other critical duties to which it must devote its attention. The problem is a long standing one and I am more interested in seeking solutions than in assessing blame.

In fact, I am pleased that our investigation indicates that most of the banks in Puerto Rico have excellent policies, procedures and compliance records with the Bank Secrecy Act. The ingenuity of money launderers is demonstrated by the fact that even in the case of some of these banks, corrupt employees nonetheless managed to subvert the bank's systems. The fact remains that though there are no foolproof mechanisms, those banks that have strong policies and procedures are much less likely to be penetrated by the insidious disease of money laundering.

I have said it before and I will say it again: bankers who help people launder money are just as much a part of the drug trade as the traffickers themselves, and it is time they were tracked down and prosecuted accordingly. I have been a strong advocate of giving our enforcement pesonnel whatever tools they need to fight the drug war. I was therefore pleased to cosponsor the Administration's money laundering bill recently introduced by Senator Thurmond as S. 1335. We will hear more about this bill today from our Justice Department witness.

I can not overstate the seriousness of the money laundering issue. I have expressed my concern to each of the bank regulatory agencies, the Justice Department, the Treasury Department and the major banking associations. I have urged each of them to do everything within their power to insure maximum compliance with the Bank Secrecy Act. This hearing is one more step in this process.

As a final point, I think it is important to emphasize that the issues we are dealing with here—our investigation and our findings—concern money laundering and do not address the soundness of financial institutions in Puerto Rico. No one, in the press, the public or anywhere else should draw the conclusion that our investigation of a particular bank or savings and loan in any way indicates that that institution is in financial trouble. So let me be clear on this. We are NOT talking about issues that normally affect the soundness or liquidity of a financial institution.

Our first witness today is Chuck Morley, the Subcommittee's chief investigator.

Chairman ROTH. Let me say, apparently the Board and its examiners have no idea of the significance of the act's value in attacking organized criminal groups. They must not read the newspapers. Unfortunately, their negligence has allowed a totally intolerable situation to perpetuate itself for years to the great detriment of the financial institutions and the citizens of Puerto Rico.

I understand the Federal Home Loan Board has other responsibilities, that this just didn't develop recently. I think it is important to know we are deeply concerned as to why this happened and how it can be prevented in the future.

I said before, and I will say it again, bankers who help people launder money are just as much a part of the drug trade as the traffickers themselves. I hope that message gets out loud and clear. It is time they were tracked down, prosecuted accordingly. I am a strong advocate of giving our enforcement personnel whatever tools they need to fight the drug war. I was happy to cosponsor the administration's money laundering bill recently introduced by the distinguished Senator Thurmond as S. 1335. We will hear more about this from our people today.

I want to emphasize that the issues we are dealing with here concern money laundering, and it does not address the soundness of financial institutions in Puerto Rico. So no one, the press, the public or anyone else, should draw any conclusions one way or the other that our investigation of a particular bank or savings and loan in any way involves their solvency.

With this, I will call upon my distinguished friend and colleague, Senator Rudman, for any comments he may have.

OPENING STATEMENT OF SENATOR RUDMAN

Senator **Rudman**. Thank you, Mr. Chairman. I thank you, again, for your leadership on these continuing hearings. I would only make a brief comment that a commom thread appears to run through everything that this committee has looked at on this subject and that is that the authorities who are initially responsible for auditing banks and determining a whole variety of things, including the subject we are talking about this morning, seem to do a very poor job throughout the Federal Government. The enforcement agencies—the Justice Department, the FBI, the Treasury Department—once they get into the situation, they seem to be able to find these problems without too much difficulty. As a matter of fact, one of our staff who was in Puerto Rico on this investigation informed me that contrary to statements made by the Federal officials involved in this particular situation, our staff was able to uncover evidence of the very kind of violations the chairman has spoken of in a matter of, really, a few moments after looking at the cash flow figures of the bank on a daily basis.

I think that is a scathing indictment, frankly, of the people who do the work. Obviously, it is one of the reasons the chairman has called this hearing. I look forward to hearing the testimony.

Chairman **Roth**. On that point, just let me say, every time we have a situation arise, they always say—the agency involved—that they don't have enough personnel. I just want to underscore what Senator Rudman has just said, that it was a matter of minutes that our investigators were able to determine some of these violations of the law. So that is no excuse. We will not accept it as such.

At this time, we will call Charles Blau, the Associate Deputy Attorney General of the Department of Justice. You understand, Mr. Blau, if you will continue standing, under the rules of our subcommittee, everyone is required to take the oath. Would you please raise your right hand?

Do you swear the testimony you will give before the subcommittee will be the truth, the whole truth and nothing but the truth, so help you God?

Mr. **Blau**. I do.

Chairman **Roth**. I understand you will not be able to testify in any detail regarding the Puerto Rican prosecutions because they are currently pending.

Mr. **Blau**. That's correct, Mr. Chairman.

Chairman **Roth**. However, we do appreciate your willingness to appear here today to give us some background information regarding Operation Tracer, as well as comments regarding the administration's money laundering bill.

TESTIMONY OF CHARLES BLAU, ASSOCIATE DEPUTY ATTORNEY GENERAL, DEPARTMENT OF JUSTICE

Mr. BLAU. Thank you, sir. I would like, first, to take the opportunity to thank you for the opportunity to appear before this very important committee and, I think, very important subject matter.

I would also like to, if I could, introduce my written statement into the record and merely summarize or highlight from that statement.

Chairman ROTH. I would appreciate you doing that. So ordered.

Mr. BLAU. What I am about to discuss basically is the problem of money laundering as we have seen it in Puerto Rico, investigating the prosecutive steps we have taken and, finally, some other action which the Department of Justice and, I believe, also the Department of Treasury would ask Congress to consider in this area.

Money laundering is an easy process. It is simply the process by which one conceals the existence of illegal source of funds and income and disguises the source of those particular funds. Quite frankly, it has become a very large business. How large? We're not quite sure. The figures range anywhere from on the small side in narcotics along from $40 billion to $150 billion annually in the country.

The Attorney General summed up the problem recently when he described money laundering as the life blood of the drug syndicate and traditional organized crime. I believe this is a very true statement in my own experiences in the field. Schemes to wash dirty money are often so sophisticated that they involve an intricate web of domestic financial institutions and foreign bank accounts, shell corporations and other business entities in which funds are moved by high-speed electronic means.

Perhaps even more disturbing, however is the increased willingness of professional people, such as lawyers, accountants, bankers of all levels from tellers to senior officials, become active participants in money laundering.

Turning to the question of Puerto Rico; in 1982, upon a noticeable increase in the currency flowing from financial institutions in Puerto Rico to the Federal Reserve, it was suspected that a similar money laundering phenomenon that we discovered early in 1979 in South Florida might be in the process of duplicating itself in Puerto Rico.

The Federal Reserve Bank in New York, through its correspondent bank, Banco de Ponce, reported a tremendous increase in the currency flow into Puerto Rico from 1980 through 1982. Puerto Rico at the time had 16 commercial banks which had increased their assets from approximately $1.6 billion to $11.74 billion for the year ending in 1981.

The Federal Reserve cash analysis for 12 of those banks showed that currency movements into Puerto Rico had increased significantly in 1980 to 1982. Specifically, the annual net surplus currency flowing into the Federal Reserve from Puerto Rico had grown from approximately $3.04 million from January of 1980 through the end of July 1980 and $528 million from January 1, 1982 through the end of October 1982, as reflected by a summary prepared by the Banco de Ponce for the Federal Reserve in New York.

When we looked at those figures, however, the question immediately came up as to how many CTR's had been filed on those banks, 16 banks in question, and we ran an analysis of those banks and we found that almost none of them had complied with the Bank Secrecy Act, and there was almost a total lack of CTR's having been filed on the cash in question.

Internal Revenue Service reviewed the reports submitted by the correspondent banks to the Federal Reserve for the years 1980, 1981, and 1982 and these reflected the majority of the banks in Puerto Rico were sending more currency to the Federal Reserve than they were receiving and, second, that they also were not reporting this currency on any CTR's.

Based upon the information then that we had, the Department of Justice and Treasury joined efforts in Operation Greenback Puerto Rico, and we began to funnel and dedicate resources to Puerto Rico to determine if we could determine the source of these moneys.

Undercover operations immediately started, primarily through a cooperating individual who had been a DEA source of information related to a heroin distribution ring between Puerto Rico and Chicago. He made a series of introductions for us where agents were placed in contact with bankers and also with currency dealers and a series of financial undercover operations then began to develop.

Thus, Operation Tracer, the designated name for the Florida-Caribbean Organized Crime Drug Enforcement Task Force, came into being.

Through monitored undercover currency operations, Greenback has identified specific individuals and institutions engaged in ongoing money laundering activities in Puerto Rico. We have discovered a loosely associated network of local financial institutions acting in concert with illegal lottery ticket dealers which we will henceforth call dealers.

This network provided a large range of financial services which collectively constitute all the traditional advantages of a "tax haven." The dealers, if desired, will provide an apparent legitimate source for illicit funds. The institutions will not report cash deposits, cash withdrawals, cash sale and redemption of bearer bank securities or the exchange of one form of currency for another.

The institutions will also provide a secure and federally insured depository for and instant access to the currency it has in possession.

These dealers are, in essence, what I would call currency speculators. The commodity involved in this particular instance in Puerto Rico involved winning tickets from the Puerto Rican lottery. These dealers, in violation of Commonwealth law, purchased winning tickets from legitimate winners from the Puerto Rican lottery for a slight premium plus the value of the tickets. They then, in turn, again in violation of local law, would sell these winning tickets for a higher price to clients who wished to legitimize illicit income, thus, a money laundering scheme has been identified and is taking place.

Normally, the dealers would take the client's winning tickets to the disbursement office of the lottery. The lottery will then issue, for the amount of the tickets, a check payable to the client or to any payee of the client's choosing.The client need not accompany the dealer to the paymaster.

Our investigation also revealed transactions with these dealers, some of them had obtained winning tickets from the lottery of Puerto Rico without even presenting the required identification to the lottery employees.

These winning checks are, on their face, valid lottery checks and in subsequent tax prosecutions are prima facie proof that the payee has, as a legitimate source of income, winnings from the lottery of Puerto Rico.

It is virtually impossible to disprove the individuals did not, in fact, win the lottery in Puerto Rico as no records are maintained of the sale of lottery tickets.

In answer to your first question, I think, which is a very important one, DEA intelligence indicates that approximately half a dozen suspected major narcotics traffickers have at one time or another claimed to have won the lottery in Puerto Rico for amounts in excess of $100,000.

Case in point is a recent income tax prosecution which was recently concluded in Miami against a known narcotics dealer by the name of Cheo Fernandez, which involved Mr. Fernandez's defense that he won two Puerto Rico lottery drawings on the same day of $112,000. The defendent, however, was convicted and the jury was not impressed with such good luck.

Information presently available demonstrates the winning lottery tickets sold by dealers are widely recognized in the financial community and are often suggested by bankers as a simple and effective way to legitimize illicit income. Dealers are likewise aware that certain bank officials at local financial institutions in Puerto Rico will conduct currency transactions without the filing of the report required under the Bank Secrecy Act.

Undercover agents have been introduced to different dealers; winning lottery tickets have been purchased from the dealers who, in turn, introduced these undercover agents to local officers of local financial institutions. These agents subsequently engaged in currency transactions with the officers of those institutions. Currency transactions conducted in violation of the law have either been unreported violations under title 31, 5313 or falsely reported in violation of title 18, U.S. Code 1001.

I should also point out that the undercover agents that we utilized in this operation were not posing as the Good Humor man. They were there acting as narcotics dealers, and they had little trouble dealing with the financial institutions under this setup.

As a result, the Department has returned approximately 12 indictments, has charged 16 persons, and the investigation is ongoing.

As you alluded to, I am precluded, however, from going into the specifics. The information that I have given you is part of the public record in this particular case.

The other disturbing part, from our standpoint, is much of the conduct encountered in these Puerto Rican investigations, although reprehensible from our standpoint, is not prosecutable under our current law. When a dealer accepts substantial amounts of currency from a narcotics trafficker and gives the trafficker a winning lottery ticket his conduct is, unfortunately, in many instances not punishable under title 31 of the U.S. Code.

Under the Bank Secrecy Act and its implementing regulations, before a government can prosecute a dealer, we would have to establish that he was, one, operating as a financial institution under the terms defined by law. More importantly and certainly more difficult to do, we would have to prove that the dealer knew about the law, that is title 31; that his activities were covered under the law and that he specifically knew his obligation to file the necessary CTR's to keep the records of his transactions.

I think what we have come to is, while we have utilized title 31 as a very important tool, we have basically missed the central point of this whole exercise. We have punished basically the filing or nonfiling of reports which has been extremely important in being able to monitor currency transactions, but we need to have a crime which actually defines what we are looking at, that is, the crime of money laundering.

As you know, the President's Commission on Organized Crime submitted a report some time ago called, "The Cash Connection: Organized Crime, Financial Institutions and Money Laundering." And that report, I think, graphically illustrated the problem which led us to the conclusion that legislation was needed to define a crime called money laundering.

On June 13, the Attorney General announced that a new bill, a bill introduced in the House as H.R. 2785 and 86, and an identical bill in the Senate, which is S. 1335. If enacted, it would prescribe all types of transactions concerning money derived from any illegal source, including narcotics trafficking and would prescribe the knowing receipt of the proceeds of any felony.

As part of the penalty for the laundering of money, the bill would provide for the forfeiture of the money which was illegally laundered. In addition, there would be substantial criminal and civil fines attached to the particular offense.

The punishment for the new money laundering statute, which we have proposed, is appropriately severe—imprisonment for 20 years, fined up to the greater of $250,000 or twice the amount of money that was involved in the offense. The bill would also provide for civil penalties of greater of $10,000 or the amount of money involved in the transaction and the forfeiture of all funds involved in the transaction. The civil and forfeiture provisions would be in addition to any fine imposed for criminal violation.

In short, the purpose of this bill is to make the laundering of money derived from criminal activity an expensive proposition for those who wish to engage in it. The bill is not directly confined to money laundering, but like a number of the sections would be particularly useful in dealing with those who handle dirty money. It would add a new section under 2322 of title 18 setting out two related but distinct offenses.

The first offense is knowingly receiving the proceeds of any Federal crime. The offense would be commited by a money launderer who received the proceeds of a Federal crime. The second offense is bringing into the United States any money or other property which had been obtained in connection with a violation of law from a foreign country, prescribing narcotics trafficking for which the punishment would be more than 1 year. This offense was intended to reach those foreign drug dealers, who would look to the United States as a place in which to invest their illicit profits, and to ensure the United States would not become a haven for such activity.

We recently had a case in Houston which was reported this last week where we have seized approximately $4 million from a Mexican drug cartel, where the drug cartel was using a Houston banking establishment for a much more attractive investment opportunity than a correspondent bank in Mexico.

In addition to setting out the new offenses, our bill provides several sections which would make it easier for the investigation of money laundering crimes generally and the tracing of the proceeds of the crimes. These amendments generally concern the Currency Transaction Reporting Act of title 31 and also the Right to Financial Privacy Act.

Turning, if I could, briefly to the right of financial privacy, one of the problems we have had throughout the years in this area is basically the notification process that the financial institutions utilize when they deal with their customers; when we come in with a grand jury subpoena saying we want a particular record. A number of these banks have read the Right to Financial Privacy Act as an ability to notify immediately the customers of the existence of that subpoena. It doesn't take a very smart person to realize that if you are in a bank with illicit funds and you are notified that the Federal Government investigative agencies are looking down your throat, you will simply fade into the woodwork and that is exactly what we have had happen over and over and over again.

[At this point in the hearing, Senator Nunn entered the hearing room.]

Mr. **BLAU**. This would allow two things to happen, this change in the bill. We would simply ask that a balance be drawn, as it was before the act, where a bank employee or bank officer who had financial information would have a good faith defense to a civil action in the event he were sued by the bank customer for disclosing that information.

We believe that this would not only protect the bank customer, but certainly would help those people who wish to and would want to provide significant criminal information to the law enforcement community.

The other thing we would like to do is amend rule 17 of the Federal rules which would clarify the authority of U.S. District Courts to issue orders commanding a person to whom a subpoena duces tecum was directed not to notify for a specific time period any other person of the existence of that subpoena. Simply, we are not asking that they never be notified, we are just asking that it be put off until some point in the future until the investigation has a chance to develop.

These provisions are intended to prevent disclosure by third party record holders, such as banks, legitimate law enforcement interests and also to protect the integrity of the investigation which is before a grand jury. Premature disclosure has potential for disrupting a number of very important investigations, and we have a number of examples of that.

I think, basically, in essence, what we think would be the appropriate way to go in this particular area is, one, to define a crime money laundering. Let's call it exactly what it is. Let's make it a criminal offense to do it. Let's have some substantial penalties to make it a very tough business.

I think that, it is my impression that, organized crime, particularly large-scale narcotics crime, cannot function nearly as well without the ability to move large sums of money. This is not an altruistic business. It is a business in every sense of the word; it is a business of money. Until we identify the people that are moving money and deal with them appropriately, we will not come to grips with this problem. This is what this bill hopes to do, and we urge your support for it. Thank you. I will answer any questions you have at this time.

Chairman ROTH. As you know, I am one of the principal sponsors of the legislation. I strongly agree that it is critically important we make money laundering in and of itself a crime. I think too many people look upon it as not a very serious white-collar violation of the law, and we have got to change that.

One of my concerns is that we make certain that all of those who would play a part in any way can be held accountable. Of course, one of the most difficult problems you have is those who are high up the corporate management as to whether or not they are involved. Let me ask you this question.

Under your proposed law, if you can show that an individual played Pontius Pilate, I guess, but knew what was going on, could he be prosecuted under this proposed legislation?

Mr. BLAU. Yes, our standard would come at him in two different ways. Under the money laundering section and also under the second section, which would be to knowingly receive the proceeds of a criminal act. Why should we excuse someone who participates in a criminal act simply because he is part of a financial institution? It makes no sense. If he is knowingly receiving proceeds of a criminal act, he is, indeed, participating in some fashion in the ultimate success of that act.

In those instances, we would be able to look to him and the proof would be whether we could show that he knew about it. That is one we would certainly be willing to take on.

Chairman ROTH. I think it is critically important that everyone from bank presidents on down understand that if they actively or passively permit money laundering in their banks they are just as guilty of being involved in the drug business as the drug dealers themselves.

Until we make them understand that and make them equally responsible, I think we are failing in our job.

Let me ask you, do you have any idea how much money is being laundered, any guesstimates, through Puerto Rico?

Mr. BLAU. Mr. Chairman, I do not have that information personally. I can only say the records that I looked at in 1980 indicate that we were seeing a very disturbing trend in much more cash coming out of Puerto Rico than what was going in. The question that immediately comes to any investigator is, what is the source of the cash? Where is it coming from? How much of it is legitimate? How much of it is not legitimate? And, basically, that is the purpose of the investigation.

Chairman ROTH. Are we talking about millions, hundreds of millions or billions?

Mr. BLAU. I can't give you good figures on that. I think the Treasury Department, the IRS, would be much more competent to do that than I.

Chairman ROTH. How many financial institutions were involved in these indictments?

Mr. BLAU. Again, as much as I can speak to, we have returned, I believe, approximately 12 indictments at the present time. We have looked at—we searched nine branches of financial institutions doing business in Puerto Rico as a result of——

Chairman ROTH [interposing]. Do you know how many different institutions have been involved?

Mr. BLAU. No, I can't say.

Chairman ROTH. It would appear, I am not certain of this, something like 10 different financial institutions have been involved in this matter.

Mr. BLAU. Again, I am precluded because of the nature of the ongoing investigations. I hate to get much more specific than that.

Chairman ROTH. Does the evidence show that Puerto Rico was but one more step in the laundering of illegal profits through offshore secrecy havens or have some people used Puerto Rico as a substitute for going offshore?

Mr. BLAU. I don't think it's a substitute, Mr. Chairman. Two factors came up. It was a very convenient way to launder large sums of money using these lottery brokers; that is one. You will always go to the point of least resistance in this area. The launderers worldwide are always looking for opportunities like this. And this was a golden one.

Second, the banking community, I think, was not as aggressive as they possibly could have been in enforcing the Bank Secrecy Act because there were very few financial records that we were able to look at during the course of 3 years involving huge sums of money. So when you have those two things and you have people who are willing not to file financial reports, you have a ready-made opportunity to exchange illicit money in a scheme. You have a golden opportunity for any illegal activity. Why wouldn't you want to use this opportunity?

Chairman ROTH. Isn't it a fact that this lottery ticket scheme was pretty well known?

Mr. BLAU. Oh, yes. It's been utilized by a number of narcotics organizations in New York, Chicago, Miami, so forth and so on.

Chairman ROTH. How about the practice right in Puerto Rico, wasn't it pretty widespread known this was a——

Mr. BLAU [interposing]. I think our information, at least the intelligence information we have been able to develop from the undercover operation, would indicate that is the case. It was suggested this is the appropriate manner in which to change illicit money to legitimate funds.

Chairman ROTH. How could the agency charged with responsibility for enforcing the law, in this case the Federal Home Loan

Bank, be so remiss when this practice is so widespread, so well known? How can you account for that?

Mr. BLAU. I can only say, sir, in my experience in Florida with the Operation Greenback there many years ago, we often looked at the same question with the bank examiners. In many instances, they were very good sources of intelligence as to what was going on in banks, and we received some very good leads.

In many instances, because of the overwhelming responsibility of looking at the total soundness or financial picture of a bank, they would not look specifically for individual criminal violations and would simply miss them, and that's the response that I would give you.

Chairman ROTH. Was the Federal Home Loan Bank in any way involved in this task force that finally uncovered this widespread problem?

Mr. BLAU. No, sir, not originally. It basically was a compilation of Justice and Treasury.

Chairman ROTH. Wouldn't you say as a practical matter they, as the first line of defense, if they were doing the job would be very much involved in the matter?

Mr. BLAU. Sir, I think it would be very difficult for me to suppose or suggest they were or were not on top of the situation without having the facts they had before them.

Chairman ROTH. Let me say as one Senator, I find it inexplicable. Here is the organization that has been charged by the Congress to enforce the law in a matter as we have made very clear by past hearings, that we hold to be a critical part of the drug enforcement law. Now we find that they seem to be sitting on their hands, for whatever reason. This is totally inexcusable and unacceptable. It makes me wonder whether some of these agenices shouldn't be revoked, done away with and reorganized. I am not asking you to comment on that. [Laughter.]

Mr. BLAU. Thank you, sir. [Laughter.]

Chairman ROTH. Senator Rudman.

Senator RUDMAN. Mr. Chairman, thank you very much. Mr. Blau, I appreciate your excellent testimony and your candor where you thought it was appropriate. One part of your statement really fascinates me and that is on page 2, at the bottom, you stated, "Puerto Rico at that time, 1980 through 1982, had 16 commercial banks which increased their assets from approximately $1.61 billion to $11.74 billion for the year ending March 1981." Is that a typographical error?

Mr. BLAU. No, sir, that is correct, to my knowledge. One of the things we like to look at, and we do look at, is an investigative technique examining cash flow. We had the same thing develop in Florida where it went from $3 billion to $8 billion in a very short period of time in the late 1970's. When you have a situation where you have a lot of excess cash coming out of a particular Federal Reserve District, you begin to wonder what is the source of that cash? How many grocery stores, supermarkets, car dealerships, condominiums, whatever the legitimate business is out there, can generate that kind of money? The answer is not very many.

Senator RUDMAN. If you draw a linear comparison between the gross national product for Puerto Rico and the growth of these bank assets, you would come to one of three conclusions: No. 1, these banks suddenly became so competitive that they beat everybody else out and all the other banks are going down the tube. Or, No. 2, an awful lot of people sure like Puerto Rico in the wintertime and were spending a lot of money there. Or, No. 3, there was a lot of money coming from other sources, and that is what your investigation at least at this point has disclosed; is that not right?

Mr. BLAU. Yes, sir; I think that was the very purpose of us going in there. We wanted to find out exactly why we saw that increase and where this money was coming in. We felt there were not that many legitimate sources available to justify this type of big jump and some had to be from illegitimate sources, and that is what we found.

Senator RUDMAN. Coming back to our chairman's question, which you answered very tactfully. I understand you are not here to castigate any other Federal agency, however, let me ask the chairman's question a different way.

The Department of Justice employs various auditors who investigate white-collar crimes of all sorts, would you think that the normal prudent bank examiner walking into a group of banks that went from $1.6 billion to $11.7 billion in one year should have at least had his curiosity aroused?

Mr. BLAU. I can put it this way. I think, on my experience, again, in Florida and that came down to when you are looking at a lot of $100 million plus money laundering operations and the same questions you are asking I was asking, how could we miss this? How did this run by? But I think it is quite simple, you take one or two bank examiners, you send them in on an audit of a bank and what are you looking at? Your primary focus is not to find criminal violations. That is basically our focus, IRS, Justice, so forth. Their focus is to, one, look at the financial picture of the bank to come to a conclusion as to its soundness and their management techniques, their accounting procedures and all the litany of things they run through. Some place down on the list is the CTR violations.

I am not saying that should not be higher on the list than it has been in the past, and I think that is a question perhaps more properly addressed to them as to what priorities did they give. But certainly from my standpoint, to answer your question as directly as I can, I think that there obviously are two roles. They are looking at one side of the coin, and we may be looking at the other side, and I am not sure how often they would look at it.

The other thing might be that traditionally their indoctrination has been to determine financial soundness and things of that nature; and their indoctrination has not been, their training has not been directed at potential money laundering, which could be a criminal violation, and I think that is part of the mix as well.

Senator RUDMAN. I think your answer is very accurate. That is precisely what we had in the Bank of Boston case; we had people in the Comptroller's Office who were not aware of the provisions of the Bank Secrecy Act. Again, we have a situation here where we passed a law and parcel out responsibility but the fact of the matter is that obviously the regulators weren't looking at their responsibility.

You would have to agree with me, I would assume, Mr. Blau, that had the priorities been different, had the examiners from this particular agency in this situation been looking at their responsibilities under the Bank Secrecy Act that it would be almost impossible to miss a change in cash flow in which assets went from $1.6 to $11.7 and that's billion, not million, dollars in the space of a little over 1 year? They would obviously have to find that if they were looking for it, would you agree with that?

Mr. BLAU. I would say it would have been a fairly obvious statistic that one would have pause over.

Senator RUDMAN. I think when you are through at the Justice Department, Mr. Blau, you might try the State Department. [Laughter.]

Mr. BLAU. You know, in all fairness, though, it is important to remember their focus is on the integrity of the institution and not on criminal violations. That is what they refer things to us for. Again, we have been very well satisfied in a number of instances, at least I am personally familiar with, where we would not have discovered huge violations. To give a case in point, the *Great American Bank* case in Florida, for example, without FDIC coming to us and saying this is what we think is going on, which is another reason I think, again, we would like to have some relief in this Right to Financial Privacy Act because we would like them to be able to give that information to us on a much more regular basis and also have the Treasury Department who supervises this be able to turn suspected violations over to the FBI or to DEA without running through an administrative hoop system that presently exists now.

Senator RUDMAN. I think my time is up. I would simply say to you, I agree with that. It has been my view ever since the Bank of Boston hearing that if we were to take that one part of the law and give it to the FBI, or the enforcement division of the Treasury Department and say you are now responsible for doing the field audit to determine if these problems exist, we would have models of compliance across the country within 12 months. The enforcers do an excellent job. The diagnosticians, not the surgeons, who are the auditors out here just gloss over the whole situation. When we finally get a case before an appropriate Justice Department grand jury or task force, we find banks awash with money nobody knew about because the people who are charged with the responsibility are not looking for it.

I thank you very much for your testimony. I think you have isolated the problem and you are right on.

Chairman ROTH. Senator Nunn.

Senator NUNN. Mr. Chairman, I would like to put a brief opening statement in the record.

Chairman ROTH. Without objection.

OPENING STATEMENT OF SENATOR NUNN

Senator NUNN. I want to congratulate you, Mr. Chairman, Senator Rudman and the majority staff for having these hearings. I have long felt that the money end of the narcotics traffic was the most important end for law enforcement to go after. I felt we ought to put more and more of our resources on that. I have, along with others, led the way in trying to get Internal Revenue Service more involved in going after people that are narcotics dealers who can't be convicted of drug trafficking, but can be convicted of tax evasion. I feel that the Bank Secrecy Act and the reporting requirements under it should be fully utilized by all agencies of Government, including the financial institution regulators.

I think this hearing is very timely, and I congratulate you on putting the focus on a very important area. I think it is obvious we are not going to stop drug traffic with any one mechanism. We are not even going to slow it down with one mechanism. But always the people involved at the top touch the money. They may never touch the drugs, but they touch the money or they wouldn't be in it.

So I think this area is enormously important, and I am pleased to be a participant. I wish, Mr. Chairman, that I could be here for the whole hearing, but we have a continuing conference in progress on the armed services bill. We have been in marathon-type sessions on that, and I will have to depart in a few minutes.

[Senator Nunn's prepared statement follows:]

PREPARED STATEMENT OF SENATOR NUNN

Mr. Chairman, I want to congratulate you and the Majority staff for the fine work you have done in bringing this important issue to the attention of Congress. Money laundering continues to be an effective means to conceal and even legitimize illegally obtained funds by those who profit through narcotics trafficking, illegal gambling, embezzlement or any of a number of other illicit activities.

This subcommittee is well aware of the increasing flow of illegal narcotics profits through banking channels. During past hearings we have learned of the astronomical sums of money that are involved in narcotics trafficking as well as the surreptitous methods that criminals often use to divert their profits through an obscure underground economy. Money laundering through the use of offshore financial institutions and businesses is an extremely valuable tool for the criminal element. Despite the increasing focus of law enforcement on money laundering schemes, recent cases suggest that the criminal element continues to locate new avenues and areas which aide and abet their illegal activities. Mr. Chairman, you and your staff are to be commended for staying on top of this issue by focusing on the problem of money laundering in Puerto Rico as an area in need of attention and reform.

I am particularly concerned by cases where financial institutions and their employees have apparently violated those provisions of the Bank Secrecy Act which were designed to help eliminate the use of legitimate financial institutions for illicit money laundering purposes. I look forward to hearing testimony this morning regarding the effectiveness of those government agencies who are mandated to enforce the Bank Secrecy Act and its accompanying regulations. Their role is an increasingly important one. It is one thing when we hear of career criminals violating or circumventing the law. However, it is yet another matter when citizens, bank officials and government agencies operate in a fashion which encourages and facilitates illegal activities.

The Bank Secrecy Act includes provisions which require financial institutions to report to the IRS cash transactions of $10,000 or more. The responsible government agencies are to insure that banks and savings and loans comply with this regulation. Congress passed such a law in order to eliminate the easy means in which criminals can move their enormous illegal profits. This law and its regulations should not receive low priority attention. The Bank Secrecy Act is potentially one of the most effective law enforcement tools in our efforts to control organized crime enterprises, yet the Act is only as effective as those who administer it.

Organized criminal activity thrives because it is enormously profitable. Controlling organized criminal activities requires a strong and combined effort by Congress, the Executive Branch and the private sector. We cannot oblige criminals by creating avenues where there is little resistance. Drug trafficking, illegal gambling and other highly profitable illicit enterprises are problems which demand the attention of both law enforcement and the private sector.

If Congress passes bad or ineffective laws we should correct them. I expect that today's proceedings will demonstrate how potentially effective laws, when not enforced, can also help create a prosperous environment for the career criminal.

Senator NUNN. Mr. Blau, I have one question for you that has not already been asked. In your testimony, you talk about the administration's bill: "Section 7 of our bill would add a new criminal facilitation offense to title 18," quoting from your statement:

"It would accomplish this by adding a new subsection (c) to 18 United States Code to provide that 'whoever knowingly facilitates the commission by another person of an offense against the United States by providing assistance that is, in fact, substantial is punishable as a principal.'"

My question is a rather technical one on this point. How does this differ with the present law which already makes aiding and abetting a criminal offense. Do we have an overlap between the two or is this totally independent of aiding and abetting?

Mr. BLAU. I think it clarifies, if you will, particularly in this area, in the money laundering area what aiding and abetting actually is. Facilitation would come into a situation where you would have an agent or financial institution actually facilitating the offense or perhaps better, you would have a lawyer who traditionally takes his client's money, puts it into a trust account and then launders it for him and says, "Well, it's always, well, I never knew what the money was, where it was from" type of thing.

If we could show a pattern of activity and the requisite knowledge, as we would have to show in any criminal case, then we might be able to show a person facilitating a criminal activity.

Senator NUNN. Have you tried these kinds of cases under the aiding and abetting statute?

Mr. BLAU. We have tried a number of them under aiding and abetting. The aiding and abetting usually is the weaker section that we have had to deal with. We have not had great success using aiding and abetting in this particular area. We feel that facilitation is a much better defined term in this area and would certainly, I think, give the judges a little bit more comfort when they are sitting there making a ruling as to which way we are going to go in this area.

Senator NUNN. You say facilitating is a better defined term. Is that based on case law? Do we have facilitating in any other criminal statutes? In other words, what is the definition? It seems to me a judge who wanted to define aiding and abetting in a broad sense could do so just as easily as he could broadly define facilitating. I am trying to understand what the difference in the two is; if it is not based on case law, is it based on some definition, I suppose, that you have in mind?

Mr. BLAU. I think it is basically, there are definitions in a number of cases as to when a person facilitates and, to be candid, they are very close; the aiding and abetting and facilitating are extremely close concepts.

We feel, however, in this particular instance, in the money laundering area, particularly, and I think this would apply to a number of different areas, that the term itself would be much better defined as a separate part of aiding and abetting. Aiding and abetting or facilitating. Subtle differences, but I think nontheless some courts have hung us out to dry on the subtle difference.

Senator NUNN. Are you basically amending the aiding and abetting statute, or is this a new statute?

Mr. BLAU. No, it would be an amendment, sir.

Senator NUNN. To the aiding and abetting?

Mr. BLAU. Yes, sir, we would add a new subsection (c) to the aiding and abetting. The subtle difference, I suppose, some courts say that aiding and abetting requires a desire that the scheme actually succeed. Under the facilitation definition, there would be no such requirement.

Senator NUNN. Is that going to be spelled out in the statute?

Mr. BLAU. We would spell it out, I think, in the statute and also in the legislative history behind the statute.

Senator NUNN. I think it is important in the legislative history at least that we have a good definition of it because it does seem to me to be very close in concept.

Mr. Chairman, I don't have any other questions for this witness.

While I have the floor briefly here, I want to thank you for your announcement yesterday, which I joined you in, regarding opening a preliminary inquiry into the Justice Department handling of the *Jackie Presser* case. I don't know that there will be any quick answers on that. I think the initiatives that we have taken in terms of beginning that inquiry are very important. We have been following this area for a long time, without regard to who was in control of the committee and without regard to who was in the White House.

I think it is enormously important to continue this bipartisan tradition. As you recall, between 1976 and 1980, we had some very, very stringent and at times very critical and, hopefully, constructive inquiries on the Labor Department's performance in this area. That was during the Democratic administration with Democrats controlling the Senate. I think you have set a good example by observing that fine tradition in this subcommittee's determination to see that labor violations by both labor leaders and management are vigorously pursued by the Government of the United States.

In this case, I think our inquiry at least preliminarily focuses on the Justice Department and the way they have handled the case rather than the Labor Department, but it is, I think, a very interesting example of whether our governmental agencies are working together. In this case, we will focus on whether the Justice Department and the FBI are working together and also certainly the ability of the Labor Department. A look at what the Labor Department is doing these days as opposed to what they were doing in the 1970's will be very interesting.

I am profoundly concerned when an investigation drags out this long. If Mr. Presser, indeed, should not be prosecuted then he has been put through the ringer during an inordinately long investigation; if, on the other hand, he should be prosecuted, then it seems to me we have some very serious questions about intergovernmental cooperation and about decisionmaking within the Justice Department.

So either way, it seems to me this is an inquiry that we should undertake, and I'm delighted to join you in that. Again, I congratulate you on your leadership.

Chairman ROTH. I thank the ranking minority member of the PSI. We do have a long tradition of bipartisan action in this area of labor racketeering. We intend to continue it. We have sent letters, as you well know, joint letters, to the Justice Department and other agencies to put them on notice that we will be moving full speed ahead on this investigation.

My only interest is that we secure the facts.

If I may make one observation back on our current subject, and I think this will probably come out in later testimony, but while you did mention the FDIC, to me it is interesting in the period from 1980 to 1984, the Federal Home Loan Bank Board made 14,000 examinations, 14,234, to be exact. The number of violations they found was 41 or 0.00288 percent. Not even one-hundredth of 1 percent, but smaller. Whereas, the FDIC in the same period made 24,880 examinations. They found 3,793 violations as compared to 41, twice as many examinations but they had 3,793 in contrast to 41 for a total of 15 percent of violations of the Bank Secrecy Act.

Those are just rough figures, but it does raise some very serious questions.

I want to thank you, Mr. Blau, for being with us today, and we have found your information very helpful. I, again, want to congratulate the Justice Department and others who cooperated in this effort for the fine work that they have done, and we look forward to continued cooperation in the future.

[Mr. Blau's prepared statement follows:]

PREPARED STATEMENT OF CHARLES W. BLAU

Progress in Investigations of Money Laundering in Puerto Rico

Mr. Chairman and Members of the subcommittee:

I am pleased to have the opportunity to appear before you today to discuss the problem of money laundering in Puerto Rico. As this Committee is fully aware, money laundering is a serious challenge to law enforcement and a clear danger to the soundness and integrity of our financial system and the fabric of our society. In my testimony today, I will discuss the problem of money laundering in Puerto Rico, the investigative and prosecutive steps we have taken and suggest some further action that Congress might take to assist our law enforcement efforts.

As the Subcommittee knows, money laundering -- the process by which one conceals the existence, illegal source, or illegal application of income and then disguises the source of their income to make it appear legitimate -- is big business. Just how big nobody knows for sure, because drug rings and organized crime families don't prepare annual reports, but the Treasury Department has estimated that Americans spend many billions of dollars each year to buy illegal drugs. Such sales would make the illegal drug trade a bigger operation than most, if not all of the Fortune 500 companies. And that is just from drug trafficking.

The Attorney General summed up the problem when he recently described money laundering as "the life blood of the drug syndicates and traditional organized crime." Unfortunately, this problem has grown in size and complexity. More people are involved, there is more money being laundered, and the schemes to wash "dirty money" are now often so sophisticated that they involve an intricate web of domestic and foreign bank accounts, shell corporations, and other business entities through which funds are moved by high speed electronic fund transfers.

Perhaps even more disturbing is the increasing willingness of professional persons such as lawyers, accountants, and bankers of all levels, from tellers to senior officials, to become active participants in money laundering. While some criminal organizations still wash their own illegally generated money by such relatively crude methods as one of their members' smuggling a suitcase full of currency out of the country for deposit in an offshore bank, a number of drug rings and other criminal syndicates now hire professionals to launder the money produced by their operations.

In 1982, upon a noticeable increase in the currency flowing from financial institutions in Puerto Rico to the Federal Reserve Bank, it was suspected that a similar money laundering phenomenon, as discovered in early 1979, in South Florida, might be duplicating itself in Puerto Rico. The Federal Reserve Bank of New York, through its correspondent, Banco de Ponce, reported a tremendous increase in the currency flow into Puerto Rico from 1980 through 1982. Puerto Rico at that time had 16 commercial banks which increased their assets from approximately 1.61 billion dollars to 11.74 billion for the year ending in March 1981. The Federal Reserve cash analysis for 12 of those banks showed that currency movement into Puerto Rico had increased significantly from 1980 to 1982. Specifically, the annual net surplus currency flowing into the Federal Reserve system in Puerto Rico had grown from 304.8 million dollars from January 1, 1980, through the end of July of 1980, to 528 million dollars from January 1, 1982 to the end of October 1982, as reflected by a summary prepared by the Banco de Ponce for the Federal Reserve Bank of New York. However, an analysis of Currency Transaction Reports (CTRs-IRS form 4789) showed almost a total lack of compliance with the Bank Secrecy Act.

The Internal Revenue Service reviewed the reports submitted by the correspondent bank to the Federal Reserve for the years 1980, 1981 and 1982 and these reflected that a majority of the banks in Puerto Rico were sending more currency to the Federal Reserve then they were receiving from it. By comparing the amounts of currency going to the Federal Reserve to the number of CTRs submitted by the banks it became very clear that almost none of the currency transactions that generated that enormous surplus were being reported properly.

Based on this information, the Departments of Justice and Treasury again joined efforts and Operation Greenback, Puerto Rico became a reality in 1983. Undercover operations immediately started with the cooperation of a confidential source, who had been intimately related to a heroin distribution operation between Chicago, Illinois and Puerto Rico. A series of introductions were made by this confidential source, which in turn led to a series of financial undercover transactions known as Operation Tracer.

Operation TRACER is a designated investigation of the Florida-Caribbean Organized Crime Drug Enforcement Task Force. The task force program was formulated at the direction of President Reagan in 1982. The Florida-Caribbean Task Force went into effect October 1, 1984, and is directed at criminal organizations involving national and international drug trade. However, Operation Greenback, from which Operation TRACER stems, has been going on in Puerto Rico since 1983 and has focused on the laundering of narcotics proceeds by and through financial institutions, an activity which is viewed as an essential element of narcotic trafficking.

Through monitored undercover currency transactions, Operation Greenback has identified specific individuals and institutions engaged in ongoing money laundering enterprises in Puerto Rico. We have uncovered a loosely associated network of local financial institutions acting in concert with illegal lottery ticket dealers (henceforth identified as "dealers"). This network provides a wide range of financial services which collectively constitute the advantages of a traditional "tax haven." The "dealers," if desired, will provide an apparently legitimate source for illicit funds. The institutions will not report cash deposits, cash withdrawals, the cash sale and redemption of bearer bank securities, or the exchange of one form of currency for another (large bills for "street money"), etc. The institution will also provide a secure (federally insured) depository for, and instant access to, the currency it has processed.

The "dealers" are, inter alia, commodity speculators. The commodity involved is "winning" tickets from the Puerto Rico lottery. These "dealers," in violation of Commonwealth law, purchase winning tickets from legitimate winners of the Puerto Rico lottery, for a slight premium plus the value of the tickets. They then in turn, again in violation of local law, sell the winning tickets, for a higher price, to "clients" wishing to "legitimize" illicit income.

Normally the "dealer" will take the client's "winning" lottery tickets to the disbursement office of the lottery. The lottery will then issue, for the amount of the tickets, a check payable to the client or to any payee of the client's choosing. The client need not accompany the "dealer" to the paymaster. Our investigation has also identified transactions wherein these "dealers" have obtained "winners" checks from the Lottery of Puerto Rico without presenting winning tickets. That is to say, that the "dealers" have acquired checks, directly from lottery employees, drawn upon the account of the Lottery of Puerto Rico, made payable to payees designated by the "dealer" without the presentation of winning lottery tickets.

These winning checks are, on their face, valid lottery checks and in subsequent tax prosecutions are prima facie proof that the payee has, as a legitimate source of income, winnings from the Lottery of Puerto Rico.

It is virtually impossible to disprove that an individual did not in fact win the lottery of Puerto Rico, as no record is maintained of the sale of lottery tickets. DEA intelligence indicates that approximately half a dozen suspected major narcotics traffickers have, at one time or another, claimed to have won the lottery of Puerto Rico for amounts in excess of $100,000. An income tax prosecution recently concluded in Miami, against suspected narcotics trafficker "Cheo" Fernandez, involved Fernandez' claim that he won two lottery drawings on the same day for $112,000. The defendant was nevertheless convicted.

Information presently available demonstrates that "winning" lottery checks, sold by the "dealers," are widely recognized throughout the banking community and are often suggested by bankers as a simple and effective method by which to legitimize illicit income. The "dealers" are likewise aware that certain bank officers at local financial institutions in Puerto Rico will conduct currency transactions without filing the reports required by Title 31.

Undercover agents have been introduced to different "dealers." "Winning" lottery checks have been purchased from the "dealers," who in turn introduced undercover agents to officers at local financial institutions. Agents then subsequently engaged in currency transactions with officers of those institutions. The currency transactions conducted in violation of the law have been either unreported in violation of Title 31 U.S.C. 5313, or falsely reported, in violation of Title 18 U.S.C. 1001.

On June 6, 1985, ten criminal complaints and one indictment were unsealed charging 17 persons with various violations of federal law relating to illegal money-laundering activities. In connection with these charges, search warrants were executed on one private residence and nine branches of financial institutions doing business in Puerto Rico. Within the following two weeks, 12 indictments were returned charging the 16 persons that had previously been charged with complaints.

In the first of what is expected to be a series of cases related to illegal money laundering activities within the Commonwealth of Puerto Rico, indictments were obtained against several banking officials and some of the "dealers."

The people indicted under Operation Tracer range from the president of a bank, two vice presidents, several branch managers and other officials to various "dealers." They have been charged, in most instances, with conspiracy to defraud and to commit other offenses against the United States; with failure to file and causing the failure to file currency transaction reports (CTRs) on transactions exceeding $10,000 in cash or its equivalent, as part of a pattern of illegal activity involving transactions exceeding $100,000 within a 12-month period. They could face, upon conviction, sentences ranging from up to 45 years in prison, in one case, all the way down to 5 years and fines from up to 2 1/2 million dollars to several thousands of dollars. I am precluded from discussing further details of these pending prosecutions.

In announcing the arrests and execution of the search warrants, however, Attorney General Edwin Meese III emphasized that the criminal prosecutions in no way reflect upon the solvency of the financial institutions through which currency was allegedly laundered.

Much of the conduct encountered in the Puerto Rican investigations, though reprehensible, is not prosecutable under our current laws. When the "dealer" accepts substantial amounts of currency from a narcotics trafficker and gives the trafficker a winning lottery ticket, his conduct is not punishable under Title 31 United States Code. Under the Bank Secrecy Act and its implementing regulations, before the government can prosecute a "dealer" we would have to establish that he has been operating as a financial institution as this term is defined in the law. More importantly, and certainly more difficult to do, we would have to prove that the "dealer" knew about the law, that his activity was covered under the law and that he specifically knew about his obligation to file the necessary CTRs and to keep records of his transactions. The Administration's proposed money laundering statute would make this transaction illegal.

As you know, on July 28, 1983, the President established the Commission on Organized Crime. Among its other responsibilities, the Commission was charged with reporting to the President from time to time -- with a final report to be submitted by March 1, 1986 -- and with making recommendations concerning any legislative changes needed to better combat organized crime and to improve the administration of justice. In October of 1984, the Commission issued an interim report to the President and the Attorney General dealing specifically with money laundering. Entitled The Cash Connection: Organized Crime, Financial Institutions, and Money Laundering, the report graphically illustrated the problem and set out draft legislation designed to deal with it. The suggested legislation contained a new money laundering offense in title 18, amendments to the Currency and Foreign Transactions Reporting Act in title 31, and Amendments to the Right to Financial Privacy Act located in title 12.

The Department of Justice and the Treasury Department have thoroughly reviewed the proposals drafted by the Commission on Organized Crime and analyzed them in light of our experiences in investigating and prosecuting money laundering cases around the country. While the recommendations of the Commission provided an excellent starting point, we concluded that modifications and refinements were needed in a number of areas, and that certain additional provisions and offenses not discussed by the Commission would also be of great assistance in combatting money launderers.

On June 13, 1985, the Attorney General announced that the Departments of Justice and of the Treasury were submitting to Congress a comprehensive legislative package related to money laundering. The bill was introduced in the House as HR. 2785 and HR. 2786, which are identical. The Senate Bill is S. 1335. If enacted, it would proscribe all types of transactions concerning money derived from any illegal source, including narcotics trafficking, and would proscribe the knowing receipt of the proceeds of any felony, including violations of foreign drug laws. As part of the penalty for the laundering of monetary instruments, the bill would provide for the forfeiture of the money which was illegally laundered. The bill also contains amendments to the Bank Secrecy Act, the Right to Financial Privacy Act, and the Federal Rules of Criminal Procedure designed to aid financial institutions in sharing information of possible money-laundering activities with federal banking and law enforcement officials.

We have carefully drafted our bill to include not only the person who, for example, deposits cash representing the proceeds of an unlawful drug transaction in a bank or uses such "dirty money" to buy a new car, but also the bank employee or car salesman who participated in the transaction by accepting the money if such a person can be proved to have known or to have acted in reckless disregard of the fact that the money involved was derived from criminal activity. Such persons, and in particular the employees of banks and other financial institutions who knowingly or recklessly help criminals dispose of the fruits of their crimes, facilitate criminal activity and are as deserving of punishment as the drug dealer or loan shark who brings them their ill-gotten cash or other monetary instruments derived from their cash.

The punishment for the new money laundering offense which we have proposed is appropriately severe: imprisonment for up to twenty years and a fine of up to the greater of $250,000 or twice the amount of money involved in the offense. Our bill also provides for a civil penalty of up to the greater of $10,000 or the amount involved in the transaction, and for the forfeiture of all funds involved in the offense. The civil penalty and the forfeiture provisions would be in addition to any fine imposed for a criminal conviction. In short, we intend to make the laundering of money derived from criminal activity an expensive proposition for those who would try it.

Turning now to other provisions in the Administration's bill, section seven of our bill would add a new criminal facilitation offense to Title 18. It would accomplish this by adding a new subsection (c) to 18 U.S.C. 2 to provide that "whoever knowingly facilitates the commission by another person of an offense against the United States by providing assistance that is in fact substantial is punishable as a principal." This offense would not be limited just to money laundering but would be particularly applicable to money launderers. For example, the new offense would be committed by one who, for a fee, took currency that he knew was derived from a drug sale and exchanged it for cashier's checks to return to the drug dealer although the person took no part in the drug sale and was indifferent as to the source of the money. It would also be committed by a chemist who manufactures and sells a lawful but difficult to obtain ingredient to a person who he knows intends to use it to produce a controlled substance.

Section eight of our bill is also not confined strictly to money laundering but, like section seven, would be particularly useful in dealing with those who handle "dirty money." It would add a new section 2322 to Title 18 setting out two related, but distinct, offenses. The first offense is knowingly receiving the proceeds of any federal felony. The offense would be committed, for example, by a money launderer who received the proceeds of any federal crime.

The second offense is bringing into the United States any money or other property which has been obtained in connection with the violation of any law of a foreign country proscribing narcotics trafficking for which the punishment under the foreign law is imprisonment for more than one year. This offense is intended to reach those foreign drug traffickers who would look to the United States as a place in which to invest their illegal profits and to insure that the United States doe not become a haven for such activity.

Section nine of our bill sets out a new chapter 202 in title 18 dealing with criminal and civil forfeitures. (It is drafted in such a way that it is easily modifiable if at some later time the Congress thought another title 18 offense ought to have a forfeiture remedy). It provides for the civil forfeiture of all funds or monetary instruments involved in the commission of the money laundering offense, and of the receiving proceeds offense, if the proceeds were obtained in violation of either a federal or foreign felony provision pertaining to controlled substances. The provisions for accomplishing civil forfeitures are patterned after the civil forfeiture provisions in title 21 with which this Subcommittee is familiar. The new chapter also provides for the criminal forfeiture of money or other property involved in a commission of the money laundering or receiving proceeds offense. Criminal forfeiture would apply to any violation of the new receiving proceeds offense, not just the receiving of money or property derived from a drug crime.

In addition to setting out new offenses and other sanctions, our bill contains several provisions designed to make easier the investigation of money laundering and the tracing of the proceeds of crime. These amendments generally concern the Currency and Foreign Transactions Reporting Act in title 31 and the Right to Financial Privacy Act in title 12.

Section three would amend the Right to Financial Privacy Act (RFPA) to define and clarify further the extent to which financial institutions may cooperate with federal law enforcement authorities in providing information which is relevant to crimes by or against financial institutions, violations of the Bank Secrecy Act in title 31, violations of the new money laundering offense, and violations of certain serious drug crimes. The effect of this amendment to the RFPA is to allow a bank or other financial institution to provide information which it has reason to believe may be relevant to one of these crimes without risking civil liability under the Act or entailing any obligation to notify the customer of such cooperation which the Act requires.

Section four contains an analagous provision in that it would amend Rule 17(c) of the Federal Rules of Criminal Procedure to clarify the authority of the United States District Courts to issue orders commanding a person to whom a subpoena duces tecum is directed not to notify, for a specified period, any other person of the existence of the subpoena. Like the amendment to the Right to Financial Privacy Act negating the financial institution's obligation in certain situations to notify the customer that it has provided evidence of crime to law enforcement authorities, this provision is intended to prevent disclosure by third party record holders, such as banks, of legitimate law enforcement interest in the records subpoenaed by a grand jury. Such premature disclosure obviously has a high potential for impairing the investigation and should not be tolerated.

The joint efforts of the Departments of Treasury and Justice to investigate and prosecute narcotics money laundering in Puerto Rico is continuing. Operation Tracer is only one of the investigations initiated by the joint task force. The congress can greatly assist our efforts by expeditiously reviewing and passing on our proposed money laundering bill.

Mr. Chairman, let me again express my appreciation for the opportunity to present our views to the subcommittee on this important area of law enforcement concern. I'll be happy to entertain any questions the Senators might have.

[Subsequent to the hearing the following letter was received from Juan Acosto Alicea, secretary of the treasury of Puerto Rico, and follows as exhibit No. 2:]

EXHIBIT NO. 2

SECRETARY OF
THE TREASURY

August 15, 1985

Hon. William V. Roth
Chairman
Committee on Government Affairs
United States Senate
Washington, D.C.

Dear Senator Roth:

I would like to address some comments in reference to the presentation made by Mr. Charles W. Blau, Associate Deputy Attorney General, before the Permanent Subcommittee on Investigations of the Committee on Government Affairs of the United States Senate on July 25, 1985.

In Mr. Blau's presentation he made some very general comments which we have already addressed in our letter of July 24, 1985 but which we wish to reemphasize so as to set the record straight. In his dissertation as to the origins of "Operation Tracer", and its corollary "Operation Greenback", a generalization was made of the Puerto Rico banking community's compliance with the currency transaction reporting requirements of the Bank Secrecy Act, which is contradictory with further statements made by Associate Deputy Attorney General Blau. He has stated that an analysis showed "almost a total lack of compliance with the Bank Secrecy Act" and proceeds to substantiate his claim with a presentation of the charges brought against 17 individual members of the banking community. His very statements disclaim an institutional involvement in the "money laundering scheme" he referred to. We most energetically object to any unsubstantiated claim of wrongdoing by the puertorrican community as it reflects to us all.

"A loosely associated network of local financial institutions acting in concert with illegal lottery ticket dealers" was allegedly uncovered by federal law enforcement officers; yet no proof of said network has been submitted to the Committee, or the community, except the arrest of 17 individual participants in various financial institutions who allegedly violated not only federal statutes but their own institution's internal procedures. There is no way that the fact of these charges can be related to a "network" of corrupt practices.

We fully support and shall continue to cooperate with federal law enforcement agencies in their endeavour to assure compliance with federal statutes affecting the Commonwealth of Puerto Rico; but we shall not stand idly by and, uncontested, allow the reputation of our community to be put in question.

Cordially,

JUAN AGOSTO ALICEA
Secretary of the Treasury

Chairman ROTH. Our next witness is Charles Morley, chief investigator of the committee. Mr. Morley, raise your right hand.

Do you swear the testimony you will give before the subcommittee will be the truth, the whole truth and nothing but the truth, so help you God?

Mr. MORLEY. I do.

Chairman ROTH. Please be seated. Would you describe your position with the subcommittee and then proceed with your testimony?

TESTIMONY OF CHARLES MORLEY, CHIEF INVESTIGATOR, PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

Mr. MORLEY. I am chief investigator with the Permanent Subcommittee on Investigations.

Mr. Chairman, during our investigation, we interviewed 42 officials representing 10 financial institutions in Puerto Rico. We also interviewed managers and examiners of the Federal Home Loan Bank Board and the Federal Deposit Insurance Corporation. While in Puerto Rico, we met with the Puerto Rican secretary of treasury, the U.S. attorney, and representatives of Operation Tracer.

[At this point in the hearing, Senator Nunn withdrew from the hearing room.]

Mr. MORLEY. In 7 of the 10 institutions, we examined policy and procedural manuals, internal audit manuals, and training documents. We also reviewed the procedures used by tellers and branch officers to process and record large cash transactions. We reviewed the bank's exempt list and currency transaction reports retained by the institutions. We then obtained the assistance of two bank examiners from the Federal Deposit Insurance Corporation and conducted a detailed examination of cash transactions of three of the seven institutions.

Four of the ten institutions reviewed accounted for the great majority of the excess currency returned to the Federal Reserve Bank by Puerto Rican banks. We examined these bank's cash transactions to determine the source of their large amounts of excess currency. And with your permission, I would like to introduce that document for the record.

[The information referred to was marked exhibit No. 3 and follows:]

EXHIBIT NO. 3

LARGE CURRENCY FLOWS THROUGH PUERTO RICAN BANKS

Total currency sent to the Fed by banks in 1984	$1.658 Billion
Total CTRs filed by Puerto Rican financial institutions in 1984	$ .657 Billion
Excess Cash	$1.001 Billion

Four banks account for majority of excess:

	Cash to Fed in Excess of CTRs filed	
#1	140.902 million	
#2	397.097 million	
#3	180.840 million	
#4	162.000 million	
Excess accounted for (88%)		881.000 million

We reviewed documentation at each of these banks that explained this excess to our satisfaction. Virtually all the excess appears to be due to transactions with exempt customers.

Mr. **Morley**. Our investigation of the financial institutions in Puerto Rico indicates that although many of them have detailed manuals, policies, and an awareness of the Bank Secrecy Act, officers and employees were nonetheless able to launder money with little effort.

The major contributing factors to this breakdown are the use of bearer certificates of deposit and poor recordkeeping practices. These factors are further aggravated by the seemingly pervasive attitude that tax evasion is harmless; therefore, a banker who assists in tax evasion is not really corrupt. Inadequate supervision by bank managers and bank regulators further compounds the problem and allows its perpetuation.

Some specific examples will illustrate how these circumstances combined to facilitate the laundering of money. I should perhaps first reiterate your comment, Mr. Chairman, that the examples we are discussing here in no way reflect on the financial stability of these financial institutions. Nor do these examples indicate that these are the only institutions where these circumstances exist.

We found bearer certificates of deposit to be the most troublesome item in our examination. As you know, bearer certificates are owned by whomever has them in their physical possession. In Puerto Rico, the interest earned by these certificates is supposed to be reported to the Puerto Rican Treasury. The Bank Secrecy Act regulations section 103.34(b) (11) requires detailed records to be kept on all certificates of deposit, bearer or registered.

We found case after case of certificates that were issued by financial institutions without any name or other identifying information appearing in the banks' so-called confidential customer file. We now know—through the undercover operations of Operation Tracer, that in some of these cases, the names appeared in so-called black books that were kept by certain officers in their locked desk drawers or file drawers. In several cases, the internal audit functions of the institutions discovered these omissions and the banks took steps to correct them, in some cases after dismissing the offending officers.

Another common practice we discovered consists of entering phony names in the bearer certificate register. I might reiterate that this is not only noncompliance with the Bank Secrecy Act, but under certain circumstances would constitute a criminal violation.

The system employed by several of the financial institutions we investigated consisted of the following: A customer wishing to buy a bearer certificate, whether for cash, check or otherwise, would be taken by an officer, generally a branch manager, to a private room. The only records that normally emerged from that room were the minimum necessary to prepare the certificate and to make an entry into the register. The cash received, or the check, frequently never went through a teller. We are not sure at this point how these bookings got into the systems, but they apparently did or the books of the banks would not have balanced for that particular day.

Of course, only the officer involved knows whether or not the name entered into the register is accurate. As an illustration, we looked at one bearer certificate register that had notations throughout such as "fat woman," "one hand," "bug-eyed," "glasses," "real name is" and then they would have some other name, "real address is" and they would have some other address.

The clerk who kept this register said these comments were on the slip of paper that emerged from the private room. Obviously, she could not guarantee the accuracy of the names on the register.

In tracing some of these transactions we found that one customer had also apparently used an alias at yet another institution. The customer had an account at one bank in an apparent alias. He then drew a consecutive series of manager's checks payable to third parties in amounts under $10,000 on that bank. These checks were then used to buy bearer certificates of deposit at the bank we examined under the same alias. We don't know who these third parties were, or if, in fact, they ever existed in reality.

It is interesting to note that after the June raids, we found numerous cases of name changes on the bearer certificate records of several institutions. This indicates to us that the initial names were false, and the institutions took steps to rectify their records following the raids.

I would like to now turn to some specific items we found at several institutions.

The former president, vice president, and branch manager of Caribbean Federal Savings and Loan were all charged with criminal violations as a result of Operation Tracer. At the time of his arrest, Raul Penagaricano, the former Caribbean Federal president, was serving as vice chairman of the Federal Home Loan Bank of New York, the agency responsible for enforcing Bank Secrecy Act compliance among savings and loans in Puerto Rico. He has since resigned both positions.

We reviewed a large number of the daily transactions at Caribbean in an effort to determine their methods of receiving and reporting large currency transactions. We also reviewed the examination steps taken by the Federal Home Loan Bank Board examiners at Caribbean. Neither review was very encouraging.

The procedure for purchasing bearer certificates at Caribbean were under the total control of the bank officers, whether the president, the vice president or the branch manager. Customers wishing to purchase bearer certificates would enter a private room with the appropriate officer and later emerge with the bearer certificate. The only documents that were issued from the room were those sufficient to prepare the certificate and to make the entries in the register. In light of the fact that Caribbean had filed only one currency transaction report during the 30 months preceding March 1985, it would appear that significant Bank Secrecy Act violations may have taken place during this period.

This situation is compounded by the fact that Caribbean did not record specific currency transactions on the tellers' tapes. It is, therefore, difficult, if not impossible, to determine which specific transactions at the bank were for currency. In fact, during our review of Caribbean's daily transactions, we found numerous items missing from the records altogether. Thus, we could not trace the true ownership or method of purchase of a significant number of bearer certificates at Caribbean. Among these were one series totaling $1.7 million and a second series totaling $1.5 million, each drawn to separate persons.

We don't know who those people were nor could we determine how they were purchased.

At one point, we asked a teller to assist us in reading another teller's proofwork. We discovered that she couldn't explain many of the entries. Needless to say, if another teller couldn't understand the tape, there is little reason to believe that an internal auditor or bank examiner could. I'm not sure the former matters, as Caribbean had no internal auditor during this period.

Finally, we should note that Caribbean never reported bearer certificate interest payments to the Puerto Rican Treasury Department nor did they maintain a list of customers exempt from filing requirements of the Bank Secrecy Act.

Again, I am speaking of prior periods. I am not speaking to the current conditions at Caribbean.

During his March 1985 examination of Caribbean, a Federal Home Loan Bank Board examiner requested copies of CTR's filed during the 30 preceding months. Caribbean produced one CTR. Given the rapid growth rate of Caribbean's balance sheet, the examiner suspected that more CTR's should have been filed and, accordingly, expanded his examination. He found a large number of apparent cash purchases of certificates of deposit during December 1984 and January 1985 in excess of $10,000 for which no CTR's were filed. The examiner described these in his draft of the final report.

Mr. Penagaricano, the president of Caribbean protested to Vincent Cerreta, former acting regional director for the Federal Home Loan Bank Board in New York stating that he was sure he could document that these transactions were in fact not currency transactions. Penagaricano later submitted such alleged documentation for the months of January and February 1985. The examiner's comments regarding the failure to file CTR's were stricken from his report unbeknownst to the examiner.

In addition, Frank Nelson, the bank examiner's supervisor, felt the examiner's terminology regarding the president's lack of understanding of the exempt qualifications was inappropriate so he took what he termed "poetic license" and struck the comments from the report. These deletions were replaced by a statement that Mr. Penagaricano would ensure correction of any deficiencies in the compliance area, even though Mr. Nelson had not spoken to Mr. Penagaricano about this matter.

With your permission, I would like to submit copies of these documents and other pertinent documents into the record.

Chairman Roth. Without objection.

[The documents referred to were marked exhibit No. 4 and follow. Other documents attached to exhibit No. 4 may be found in the subcommittee files.]

EXHIBIT NO. 4

Name: CARIBBEAN FEDERAL of Puerto Rico

Examination Date: 3-11-85

Examiner in Charge William Otto

Examiner re. Currency Trans: William Otto

Comments Attached

Exception Sheet None

Prog. of Working Paper Attached

Other:

EXHIBIT X

Includes: Comments

Currency Transaction Reports plus Deposit slips

FHLBB Form 919

COMMENTS

1. Net Worth

The ratios of net worth to total assets and to savings capital at December 31, 1984 have increased to 2.0% and 2.5%, respectively, from 0.5% and 0.7% at the previous examination. However, these ratios remain well below the latest available peer group averages. These low ratios are attributed to the association's rapid growth, and the $25,000 loss for the last quarter of 1984, due to non-operating expenses.

The net worth requirement was met at December 31, 1984 and during the two month period ended February 28, 1985.

President Penagaricano stated that the ratio of net worth to total assets has increased steadily and he feels the net worth ratio will increase to 3% by June 30, 1985 or September 30, 1985.

2. Currency and Foreign Transaction Reporting Act

The association has prepared only one form 4789 during the 30 month period under review. However, a test check of deposit slips for the months of December 1984 and January 1985 disclosed 32 cash deposits of $10,000 or more, most of which appear to have been used to open savings certificates.

President Penagaricano stated that he will investigate this matter to insure compliance in the future.

Subsequent to the completion of the examination, Mr. Penagaricano submitted supporting documentation to show that the transactions were not cash transactions but were, in fact, transfers from maturing CD's to new CD's.

3. Financial Management

The association continues to invest most of its capital in fixed rate and term first mortgage loans secured by single-family dwellings. During the period under review the Board of Directors approved a risk management plan which reduced the term of these loans from 30 years to 10 or 15 years.

However, the association does not offer shorter term or adjustable rate mortgages, despite the existence of a strong asset/liability mismatch. As shown on page 15, 84.5% of total savings capital matures in one year or less, and 68.0% of total savings are in accounts of $50,000 and over maturing in one year or less.

President Penagaricano stated that the bank has not been offering variable rate mortgage loans because the Commonwealth of Puerto Rico authorizes variable rate mortgages only in a way that makes it impossible to sell them. He continued by stating that the bank has reduced the remaining life of mortgage loans to an average of 8 years.

4. Directors' Attendance

As shown on page 3 of this report, Director Eduardo Ferrer attended only 17 of 44 regular Board of Directors' meetings held during the period under review. In addition, Director Ferrer has been cited in previous reports of examination for not attending a material number of board meetings.

President Penagaricano stated that Director Eduardo Ferrer has other business commitments which preclude his regular attendance at meetings and, regardless, is a valued member of the board.

5. Community Reinvestment Act

A review of association activity for compliance with the Community Reinvestment Act did not disclose any material areas of concern.

The following additional pages are included in this report: 3, 4, 5, 6 and 15; other standard report pages have been omitted.

rls

52. Currency and Foreign Transaction Reports [illegible]

The Association has prepared only [illegible] Form 4789 during the 30 month period under review. However, a test check of deposit slips for the months of December 1984 and January 1985 disclosed 32 cash deposits of $10,000 or more, most of which appear to have been used to open savings certificates.

President Penagaricano stated that he ~~has~~ been informed, that form 4789 instructions states that any person who has a savings account and all the information is available, records are kept for that savings account, and if the same person made a cash deposit of $10,000 or more in the same savings account form ~~4789 and not to be filed.~~

will investigate the matter to insure compliance in the future.

Subsequent to the completion of the examination, Mr Penagaricano submitted supporting documentation to show that the transactions were not cash transactions but were, in fact, transfers from maturing CD's to new CD's.

Bill - Subsequent ~~to~~ this being received, a letter from Penagaricano indicated that these were not cash transactions but rather, resulted from transfers from other savings into money markets (the attached supporting data). MC

4789
5 Currency Transaction

The Association has prepared only 1 form 4789 during the 30 month period under review. However, a test check of deposit slips for the months of December 1984 and January 1985 disclosed 32 cash deposit of $10,000 or more.

We have been informed thru the same form 4789 instruction that any person who has a saving account and all the information is available thru the records kept for that saving acct, that if he deposits $10,000.- or more in that same saving account, form No. 4789 had not to be filled.

CARIBBEAN FEDERAL SAVINGS BANK
P. O. BOX CF, CAROLINA, PUERTO RICO 00628 · TEL. (809) 762 · 5050

April 8, 1985

Mr. Vincent A. Cerreta
Assistant District Director Examinations
Federal Home Loan Bank Board
One World Trade Center, Floor 88
New York, NY 10048

Dear Vince:

After finishing the Audit performed by the Federal Home Loan Bank Board of Caribbean Federal Savings Bank of Puerto Rico, I feel proud and satisfied for the quality of the auditing and its result. Said audit ended on April 4, 1985. It was executed by Mr. William Otto.

Inasmuch as I have always been a perfectionist, there is one item in the Auditing Report which sounded strange to me and I instructed our branch manager to look into the matter. Mr. Otto informed to me that he had made a spot check of the months of January and February of 1985 looking for the compliance and filling out of form 4789 of the Treasury Department. Since he was leaving on Thursday morning, and Caribbean Federal Savings, because of the Holly Week, was closing the doors to the public at 12:00 that day and on Friday and Saturday for the full day, it was not until Monday, April 8, that our Manager was instructed to revise all deposits and transactions for both months. We have found out that there has not been any violations at all. The confusion is due to the fact that when a certificate is cancelled at maturity and a new one is issued, we cancel the old one and always issue a new certificate. On the deposit slip of the new certificate, we print the amount being transferred in the space provided for "cash". That does not means that a new certificate was issued in cash. The original certificate, maybe opened months before, was established by check.

Enclosed will find photostatic copies of all the documents that shows the above mentioned observations.

Sincerely yours,

Raul Peñagarícano
President

mdr
enclosures

Congressional Research Service
The Library of Congress
Translation (Spanish)

Washington, D.C. 20540

Caribbean Federal Savings Bank of Puerto Rico

MEMORANDUM

TO: Managers

FROM: Raul Penagaricano, President

DATE: May 31, 1985

SUBJECT: Department of Treasury Regulations regarding cash transactions

The present memorandum has as its purpose to bring to your attention a matter, which although you have been aware of it since some time ago, I want to emphasize the importance of the same. I am referring to the requirement by the Federal Department of the Treasury that every cash transaction of $10,000.00 or more must be reported by us to the Internal Revenue Service. When I speak of any cash transaction of $10,000.00 or more, this means that when a customer brings such an amount to be deposited in a savings account, to open a savings certificate, to purchase traveler's checks, etc., it is required that Form 4789 be prepared and that the same be forwarded to the Internal Revenue Service within 15 days after the funds are received.

We do not have to fill out Form 4789 if the cash transactions of $10,000.00 or more are reasonable, if our customer, due to the type of business he is in, habitually deposits money in cash. Form 4789, under the inset "exceptions"which appears on the back, has additional information referring to the above-mentioned item. For those persons on whom no Form 4789 has to be filled out, the bank has to carry a record with their name, Social Security number and amount involved. This record does not have to be sent anywhere. It merely must be kept available for any investigation.

There is another form that has to be complied with when there are transactions in currency or negotiable instruments in amounts over $5,000.00, and covers only when there is an international transaction in currency or negotiable instruments. This form is 4790 and has to be sent to the Internal Revenue Service within the first 30 days after the transaction. Copies of both Form 4789 and Form 4790 must be kept for five years.

Translated by Wesley Kerney- CRS - Language Services - 7/19/85 - amc

[illegible]

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MEMORANDO

A : Gerentes

DE : Raul Penagaricano, Presidente

FECHA : 31 de mayo de 1985

ASUNTO: **Reglas del Departamento del Tesoro sobre transacciones en efectivo.**

El presente memorial propende el traer a vuestra atención un asunto, que aunque es de conocimiento de ustedes desde hace algún tiempo, quiero por la presente enfatizar la importancia del mismo. Me refiero al requerimiento del Departamento del Tesoro Federal, a que toda transacción de $10,000.00 o más en efectivo, debe ser informada por nosotros al Internal Revenue Service. Cuando menciono cualquier transacción desde $10,000.00 o más en efectivo, esto significa que cualquier cliente que traiga esa cantidad para depositar una cuenta de ahorro, abrir un certificado de ahorro, comprar cheques de viajero, etc., se requiere el que se prepare la forma 4789 y se someta la misma a Internal Revenue Service dentro de los 15 días en que se reciben los fondos.

No tenemos que llenar la forma 4789 si las transacciones en efectivo de $10,000.00 o más son razonables, ya que nuestro cliente, por costumbre, debido al tipo de negocio a que se dedica, es corriente que deposite dinero en efectivo. La forma 4789 y bajo el inciso "exceptions" que aparece al dorso de la misma, tiene información adicional referente a lo anteriormente aludido. Aquellas personas a las que no se les llena la forma 4789, el banco tiene que llevar un record con nombre, el seguro social y la cantidad envuelta. Dicho record no tiene que enviarse a ningun lugar. Solamente, tenerla disponible para cualquier investigación.

L 85 10: 47

Existe otra forma que tiene que ser cumplimentada cuando existen transacciones en moneda o instrumentos negociables por más de $5,000.00 y cubre solamente cuando existe una transacción internacional de moneda o instrumento negociable. Esta forma es la 4790 y tiene que ser remitida al Internal Revenue Service dentro de los primeros 30 días a partir del incidente. Tánto la forma 4789 como la 4790, las copias de la mismas, tienen que guardarse por cinco años.

mar

W/6

J. Gorman
Dist 2

Federal
Home Loan
Bank
Board

Memo

OFFICE OF EXAMINATIONS AND SUPERVISION

INTER-OFFICE COMMUNICATION

FROM Edward J. O'Connell, III

TO William J. Schilling
Director

DATE June 21, 1985

SUBJECT Caribbean FSB of
Puerto Rico
Carolina, PR
FHLBB No. 7346

This is in response to your request that I contact Vince Cerreta regarding the deletion of a comment from a recently completed report of examination of this institution which described violations of the Currency and Foreign Transactions Reporting Act (the Bank Secrecy Act). The report of examination has been forwarded to the Supervisory Agent, however, the report has not yet been transmitted to the institution.

I became aware of this comment deletion through a telephone conversation with the FHLBank of New York. Today I called Acting District Director James J. Gorman and recommended that the report of examination be amended to include the previously deleted comment. Also I suggested that Mr. Gorman and Supervisory Agent Vigna call me on Monday June 24, 1985 to further discuss this matter. Mr. Vigna was not in the office today. Also as you know it is not unusual to add, delete or modify comments based on the receipt of additional information or the detection of typing or technical errors.

Mr. Cerreta in a telephone conversation this afternoon explained to me the reason for deletion of the comment regarding the CFTR Act which is summarized as follows:

The pencil copy of the report of examination contained a comment citing several instances of failure of the institution to file required 4789 forms with the IRS. Before the report of examination was processed by the District Office Mr. Cerreta was contacted by Raul Enrique Penagaricano-Soler, president of Caribbean Federal Savings Bank who stated that he could not believe there were so many failures to file the 4789 forms. Mr. Penagaricano-Soler apparently subsequently advised Mr. Cerreta that he had checked the institution's records and determined that in fact these transactions did not involve cash, although the institution's records had mistakenly shown the transactions to be cash, and consequently there was no requirement to file the 4789 forms with IRS and further that there was no violation by the institution of the CFTR Act. Mr. Penagaricano-Soler stated that the transactions actually involved not cash but the transfer from one CD to another. He advised Mr. Cerreta that he had journal entries to support his statement. This information was supplied to Mr. Cerreta who reviewed the material and concluded that the documentation supported Mr. Penagaricano-Soler's claim that there was no violation of the CFTR Act. Mr. Cerreta continues to believe that the material submitted by the institution supports its position that there was no CFTR Act violation for failure to file 4789 forms with IRS.

My own view is that it is best to present the examiner's comment in the report of examination. The institution as in all other situations will have an opportunity to comment and supply whatever information it has should it disagree with the comment.

My understanding is that Mr. Raul Enrique Penagaricano-Soler enjoyed an excellent reputation. His June 6, 1985 indictment on one count of conspiracy, two counts of failing to file, causing the failure to file, of a currency transaction report on a currency transaction exceeding $10,000, as part of a pattern of illegal activity involving transactions exceeding $100,000 within a 12-month period and three counts of failing to file, and causing the failure to file, of a currency transaction report on a currency transaction exceeding $10,000, at a minimum raises question as to his integrity. The Board has suspended and prohibited Mr. Penagaricano-Soler as an officer and director of Caribbean FSB and also suspended him as a director of the FHLBank of New York.

Edward J O'Connell III
Assistant Director for
Regional Operations

EJO'C:ch

I concur with the
actions taken

6-22-85.

Mr. **Morley**. We reviewed the documentation sent by Mr. Penagaricano to the Bank Board and have found it inadequate. First of all, rather than addressing December 1984 and January 1985, it addresses January and February 1985. Likewise, it addresses only some of the transactions noted as exceptions by the examiner.

Finally, given the total disarray of the institution's records with respect to currency transactions, it would be necessary to see the actual photocopy of the check used to purchase the certificates before we would be convinced that they were purchased by check rather than by currency. This type of documentation was not included in the documentation sent to Mr. Cerreta. When these exceptions were raised by our staff with Mr. Cerreta, he stated that Mr. Penagaricano probably knew more about the Bank Secrecy Act than Mr. Cerreta did.

In January 1985, the internal auditor at Banco Financiero de Puerto Rico discovered that the customer confidential card file maintained for the holders of bearer certificates of deposit had numerous cards which contained no names, addresses or Social Security numbers. The internal auditor and the audit committee board member reported this noncompliance in a letter to the president, Mr. Munoz. Mr. Munoz stated that he then discussed this particular violation with the executive vice president and told him to see that it was corrected.

Our investigation of the card files involved determined that several large depositors were personal customers of Banco Financiero's marketing officer and that their existence was unbeknownst to that officer's supervisor, the branch manager, or the president, notwithstanding the fact that at least one of these customers could probably be categorized as one of the bank's largest depositors.

We also uncovered an unusual situation at Banco Financiero and the Banco de Ponce involving the purchase of millions of dollars of managers' checks with what appear to be bad checks. We documented $1.7 million of these transactions at Banco Financiero during the period July 23, 1984, through October 30, 1984, even though we did not review every day during this period.

It appears that a courier delivered numerous $9,500 checks drawn by Rodal Magazine Distributors on another bank to Banco Financiero on a daily basis. Daily transactions ran as high as $150,000. The courier, with the assistance of a bank officer, would buy numerous managers' checks, payable to third parties. These checks were then redeposited the next day right back into the account of Rodal from which the funds were taken in the first place, thus covering the otherwise bad checks. These transactions were apparently given the blanket approval of Angel Alvarez, a board member with Banco Financiero.

[A summary of these transactions follows:]

BANCO FINANCIARO

Daily Amount of Manager's Checks Purchased
by Rodal Magazines Distributors, Inc.
on Days Reviewed

Monday	7/23/84	$19,000.00
Tuesday	7/24/84	28,500.00
Thursday	7/26/84	58,500.00
Monday	7/30/84	28,500.00
Tuesday	7/31/84	38,500.00
Wednesday	8/1/84	38,000.00
Thursday	8/2/84	19,000.00
Friday	8/3/84	44,000.00
Monday	8/6/84	40,500.00
Tuesday	8/7/84	33,340.45
Wednesday	8/8/84	28,500.00
Thursday	8/9/84	28,500.00
Friday	8/10/84	28,500.00
Monday	8/13/84	45,250.00
Tuesday	8/14/85	35,000.00
Thursday	8/16/84	36,302.52
Friday	8/17/84	38,000.00
Monday	8/20/84	38,963.00
Wednesday	8/22/84	47,500.00
Tuesday	9/4/84	54,500.00
Wednesday	9/5/84	57,000.00
Thursday	9/6/84	82,613.10
Friday	9/7/84	56,500.00
Monday	9/10/84	55,500.00
Monday	10/1/84	150,040.50
Wednesday	10/3/84	$66,000.00
Tuesday	10/9/84	66,000.00
Friday	10/19/84	84,000.00
Monday	10/22/84	75,000.00
Tuesday	10/23/84	152,500.00
Tuesday	10/30/84	84,000.00
TOTAL		$1,658,009.57

Mr. MORLEY. During 1 week in April 1985—this is 1 week, remember—Rodal purchased over $1 million in managers' checks from the Banco de Ponce, again using worthless checks drawn on another bank. The Banco de Ponce immediately detected the scheme and ended it. At this point, we do not know what the purpose of these transactions was. It is clear, however, that these transactions violated Banco Financiero's policies and were apparently conducted unbeknownst to the president of the bank, Mr. Munoz.

Mr. Chairman, as I am neither a banker nor a bank examiner, I would hesitate to make final recommendations based upon our investigation of money laundering in Puerto Rico. However, I think we can suggest that perhaps those experienced in these fields could explore certain possibilities.

Our investigation of the daily teller's transactions immediately surfaced problems in several of the institutions we surveyed. We determined which days to review at any given branch by reviewing their cash transactions with their correspondent bank or the Federal Reserve. This surfaced unusual cash activities at particular branches on specific dates. Perhaps this same technique could be used by banks and their regulators in determining compliance with the currency-reporting requirements of the Bank Secrecy Act.

It is virtually impossible for an internal auditor to audit large currency transactions in an institution that does not specifically record currency transactions on the teller's tape. On the other hand, institutions we reviewed which had on-line computer systems or which manually prepared cash-in, cash-out tickets, left very easy trails for internal audit to follow. Bank managers may wish to ensure that their systems leave a clear audit trail for currency transactions in order to further protect themselves from being victimized by money launderers and their accomplices.

A significant number of the cases involved in Operation Tracer concerned officers who had the apparent authority to act alone in issuing bearer certificates or managers' checks. The nature of these instruments would seem to dictate that two responsible officers should be involved in their issuance.

Several banks we reviewed issue certificates of deposit and managers' checks only to established customers. Managers' checks and certificates of deposit over specified amounts require full identification just as would be required in cashing a third-party check. This is an extension of the "know your customer" policy such as that recently implemented by the Bank of Boston. This, again, seems to be good insurance at little cost.

Several banks in Puerto Rico require daily currency analyses to be conducted by their operations officers at the branch level. This immediately identifies any unusual currency flows and alerts senior management to the possibility that these may be unreported. These banks view this additional step as sound cash management which goes hand in glove in determining the branch's daily cash needs, a process all banks must go through regardless.

In conclusion, it is our impression that though the Bank Secrecy Act has been a matter of widespread attention in some quarters of the Puerto Rican financial community, a few bankers and bank officers have caused a near calamitous situation in that community.

The institutions involved have learned the painful lesson learned by so many before—that a careless approach to the Bank Secrecy Act can end in disaster. Our investigation indicates that all these situations could have been detected and quickly remedied with minimal amount of cost or effort on the part of the banks and their regulators.

Chairman ROTH. Thank you, Mr. Morley. I want to emphasize what you say in the last paragraph. What we found to be true of some banks and officials should not be taken as true of all financial institutions. As you say at the beginning of your conclusions, you are neither a banker nor a bank examiner, but I take it you don't have to be very sophisticated in financial matters not to wonder why—let me read your third paragraph on the first page.

> Four of the ten institutions reviewed accounted for the great majority of the excess currency returned to the Federal Reserve Bank by Puerto Rican banks. We examined these bank cash transactions to determine the source of their large amounts of excess cash.

I would like to go back to our prior witness who I think very properly pointed out that the bank examiners have many things to look at, of which bank secrecy is only one. But isn't the fact there were these huge sources of excess currency a loud and clear bell that something is wrong?

Mr. MORLEY. Well, it certainly indicates that there is a great possibility that something is amiss.

Chairman ROTH. At least you should investigate it.

Mr. MORLEY. I certainly agree. It is a classic indication something is going on there that is not readily explained.

Chairman ROTH. You can't say just because you had so many other things to do that you didn't notice this large flow of currency, could you? Isn't that going to be perfectly obvious to any bank examiner?

Mr. MORLEY. If you had the data available, yes, it would be obvious. Now, one question that arises in our minds is, did they in fact, have the data available? If you recall, in the Bank of Boston investigation, we discussed with the regulators the sharing of information and the question arises whether or not the Federal Home Loan Bank Board actually took the initiative to get these figures from the Federal Reserve. Of course, they are readily available in Puerto Rico and it did not take long to get these figures. They are right there.

Chairman ROTH. If you were examining these accounts and you saw this large flow of currency, wouldn't one of the first things you would want to do then is look at the CTR's?

Mr. MORLEY. Yes, absolutely.

Chairman ROTH. Would it raise any questions to the fact that very few were in existence at some of these institutions?

Mr. MORLEY. Absolutely. I would want to get an explanation for that.

Chairman ROTH. I just find it incomprehensible the lack of adequacy of the review, particularly when you go on with your other testimony, you say on page 2, in the case of bearer certificates register how very, very little information was available. How did they identify them? "Fat woman," "one hand," "bug-eyed," "glasses." The only records that normally emerged from that room was the minimum necessary to prepare the certificates to make an entry into a register. Would that be some kind of alarm signal if you were a bank examiner even if you weren't the most sophisticated in the world?

Mr. MORLEY. Again, I would think so. Maybe, we are again seeing surface again—as we did in the Comptroller's Office in our previous investigation—a lack of knowledge by senior officials. They have not addressed the issue of how money is laundered, what are the telltale signs; what is the Bank Secrecy Act and how does it fit into all of this.

Chairman ROTH. In your conclusion you say, "It is virtually impossible for an internal auditor to audit large currency transactions in an institution that does not specifically record currency transactions on the teller's tape."

How well trained do you have to be to dope that out?

Mr. MORLEY. I had long discussions with the two FDIC examiners with whom I was working. I have to say they were rather aghast at the situation. They said they have never seen anything like this. They were very concerned for any number of reasons. Again, you look at this and you say how on earth do you balance it? Apparently—not apparently, this is what we were told by the tellers and other people in the banks, you start with beginning cash; you have a figure for beginning cash; you have a figure for ending cash, and you have all these transactions over on the side; some are recorded and some are not. Maybe they have an adding machine tape of checks and an adding machine tape of certificates of deposit, adding machine tape of manager's checks. With all this, they hope to balance it.

We asked, what if it doesn't balance? We never got an answer. They do not have specific entries for cash. Cash is what we call in accounting terminology a forced figure. If it is not there to back into, I don't know what you do. I suppose you go to cash over and under account and hope that balances it out over a period of months.

Chairman ROTH. Like you, I am not sophisticated in intricate banking matters. I can barely balance my own account.

Mr. MORLEY. I am sure you record cash, though, Senator.

Chairman ROTH. I don't have much cash flow, to be honest with you. [Laughter.]

It really shocks me, at least in some of these institutions, the lack of internal controls and records. It is not only a question of the Bank Secrecy Act, but I really question how they can look at the solvency and other requirements of the law.

I want to thank you very much for your testimony. Senator Rudman?

Senator RUDMAN. I just thank Mr. Morley for his usual very good and thorough testimony and excellent presentation on short notice. I don't have any questions for Mr. Morley.

Mr. MORLEY. Thank you, Mr. Chairman.

[Mr. Morley's prepared statement follows:]

STATEMENT OF
CHARLES MORLEY

Introduction

During our investigation we interviewed 42 officials representing 10 financial institutions in Puerto Rico. We also interviewed managers and examiners of the Federal Home Loan Bank Board and the Federal Deposit Insurance Corporation. While in Puerto Rico we met with the Puerto Rican Secretary of Treasury, the U.S. Attorney, and representatives of Operation Tracer.

In 7 of the 10 institutions, we examined policy and procedural manuals, internal audit manuals and training documents. We also reviewed the procedures used by tellers and branch officers to process and record large cash transactions, the bank's exempt list and Currency Transaction Reports retained by the institutions. We then obtained the assistance of two bank examiners from the Federal Deposit Insurance Corporation and conducted a detailed examination of cash transactions of 3 of the 7 institutions.

Four of the 10 institutions reviewed accounted for the great majority of the excess currency returned to the Federal Reserve Bank by Puerto Rican banks. We examined these bank's cash transactions to determine the source of their large amounts of excess cash.

Results of Examination

Our investigation of the financial institutions in Puerto Rico indicates that although many of them have detailed manuals, policies and an awareness of the Bank Secrecy Act, officers and employees were nonetheless able to launder money with little effort. The major contributing factors to this breakdown are the use of bearer certificates of deposits and poor recordkeeping practices. These factors are further aggravated by the seemingly pervasive attitude that tax evasion is harmless; therefore a banker who assists in tax evasion is not really corrupt. Inadequate supervision by bank managers and bank regulators further compounds the problem and has allowed its perpetuation.

Specific Cases

Some specific examples will illustrate how these circumstances combined to facilitate the laundering of money. I should perhaps first reiterate your comment, Mr. Chairman, that the examples we are discussing here in no way reflect on the financial stablility of these financial institutions. Nor do these examples indicate that these are the only institutions where these circumstances exist.

We found bearer certificates of deposit to be the most troublesome item in our examination. As you know, bearer certificates are owned by whomever has them in their physical possession. In Puerto Rico, the interest earned by these certificates is supposed to be reported to the Puerto Rican Treasury. The Bank Secrecy Act regulations section 103.34(b)(11) requires detailed records to be kept on all certificates of deposit, bearer or registered.

We found case after case of certificates that were issued by financial institutions without any name or other identifying information appearing in the banks so-called confidential customer file. We now know -- through the Undercover Operations of Operation Tracer, that in some of these cases, the names appeared in so called "black books" that were kept by certain officers in their locked desk drawers or file drawers. In several cases, the internal audit functions of the institutions discovered these omissions and the banks took steps to correct them -- in some cases after dismissing the offending officers.

Another common practice we discovered consists of entering phony names in the bearer certificate register. I might reiterate that this is not only non-compliance with the Bank Secrecy Act but under certain circumstances would constitute a criminal violation. The system employed by several of the financial institutions we investigated consisted of the following: A customer wishing to buy a bearer certificate, whether for cash, check or otherwise would be taken by an officer, generally a branch manager, to a private room. The only records that normally emerged from that room were the minimum necessary to prepare the certificate and to make an entry into the register. The cash received -- or the check --frequently never went through a teller. We are not sure at this point, how these bookings got into the systems, but they apparently did or the books of the banks would not have balanced for that particular day. Of course, only the officer involved knows whether or not the name entered into the register is accurate. As an illustration, we looked at one bearer certificate register that had notations throughout such as "fat woman" "one hand" "bug-eyed" "glasses" "real name is ____", etc. The clerk who kept this register said these comments were on the slip of paper that emerged from the private room. Obviously, she could not guarantee the accuracy of the names on the register she maintained.

In tracing some of these transactions we found that one customer had also apparently used an alias at yet another institution. The customer had an account at one bank in an apparent alias. He then drew a consecutive series of manager's checks payable to third parties in amounts under $10,000 on that bank. These checks were then used to buy bearer certificates of deposit at the bank we examined under the same alias. We don't know who these third parties were, or if, in fact, they actually exist.

It is interesting to note, that after the June raids, we found numerous cases of name changes on the bearer certificate records of several institutions. This indicates to us that the initial names were false, and the institutions took steps to rectify their records following the raids.

I would like to now turn to some specific items we found at several institutions.

The former President, Vice President and Branch Manager of Caribbean Federal Savings and Loan were all charged with criminal violations as a result of Operation Tracer. At the time of his arrest, Raul Penagaricano, the former Caribbean Federal President, was serving as Vice Chairman of the Federal Home Loan Bank of New York, the agency responsible for enforcing Bank Secrecy Act compliance among savings and loans in Puerto Rico. He has since resigned both positions. We reviewed a large number of the daily transactions at Caribbean in an effort to determine their methods of receiving and reporting large currency transactions. We also reviewed the examination steps taken by the Federal Home Loan Bank Board examiners at Caribbean. Neither review was very encouraging.

The procedure for purchasing bearer certificates at Caribbean were under the total control of the bank officers, whether the President, the Vice President or the branch manager. Customers wishing to purchase bearer certificates would enter a private room with the appropriate officer and later emerge with the bearer certificate. The only documents that were issued from the room were those sufficient to prepare the certificate and to make entries in the register. Adding machine tapes reflecting the count of the currency were destroyed. Witnesses recalled recurring instances where unidentified customers came in with large amounts of currency to buy bearer certificates. This currency never went through the tellers at Caribbean and therefore no record exists of these specific transactions beyond the issuance of the certificates and the entries in the register. In light of the fact that Caribbean had filed only one Currency Transaction Report during the 30 months preceding March 1985, it would appear that significant Bank Secrecy Act violations may have taken place during this period.

This situation is compounded by the fact that Caribbean did not record specific currency transactions on the tellers tapes. It is therefore difficult, if not impossible, to determine which specific transactions at the bank were for currency. In fact, during our review of Caribbean's daily transactions, we found numerous items missing from the records altogether. Thus, we could not trace the true ownership or method of purchase of a significant number of bearer certificates at Caribbean. Among these were one series totalling $1.7 million and a second series totalling $1.5 million.

At one point, we asked a teller to assist us in reading another teller's proof work. We discovered that she couldn't explain many of the entries. Needless to say, if another teller couldn't understand the tape, there is little reason to believe that an internal auditor or bank examiner could. I'm not sure the former matters as Caribbean had no internal auditor during this period.

Finally, we should note that Caribbean never reported bearer certificate interest payments to the Puerto Rican Treasury Department nor did they maintain a list of customers exempt from the filing requirements of the Bank Secrecy Act.

During his March 1985 examination of Caribbean, a Federal Home Loan Bank Board examiner requested copies of CTRs filed during the 30 preceding months. Caribbean produced one CTR. Given the rapid growth rate of Caribbean's balance sheet, the examiner suspected that more CTRs should have been filed and accordingly expanded his examination. He found a large number of apparent cash purchases of certificates of deposit during December 1984 and January 1985 in excess of $10,000 for which no CTRs were filed. The examiner described these in his draft of the final report of examination.

Mr. Penagaricano, the President of Caribbean protested to Vincent Cerreta, former Acting Regional Director for the Federal Home Loan Bank Board in New York stating that he was sure he could document that these transactions were in fact not currency transactions. Penagaricano later submitted such alleged documentation for the month of January and February 1985. The examiner's comments regarding the failure to file CTRs were stricken from his report unbeknowst to the examiner. In addition, Frank Nelson, the bank examiner's supervisor, felt the examiner's terminology regarding the President's lack of understanding of the exempt qualifications was inappropriate so he took what he termed "poetic license" and struck the comments from the report. These deletions were replaced by a statement that Mr. Penagaricano would ensure correction of any deficiencies in the compliance area, even though Mr. Nelson had not spoken to him.

We have reviewed the documentation sent by Mr. Penagaricano to the Bank Board and have found it inadequate. First of all, rather than addressing December, 1984 and January, 1985, it addresses January and February of 1985. Likewise it addresses only some of the transactions noted as exceptions by the Examiner. Finally, given the total disarray of the institution's records with respect to currency transactions, it would be necessary to see the actual photocopy of the check used to purchase the certificates before we would be convinced that they were purchased by check rather than by currency. This type of documentation was not included in the documentation sent to Mr. Cerreta. When these exceptions were raised by our staff with Mr. Cerreta he stated that Mr. Penagaricano probably knew more about the Bank Secrecy Act than Mr. Cerreta did.

In January of 1985, the internal auditor at Banco Financiero de Puerto Rico discovered that the customer confidential card file maintained for the holders of bearer certificates of deposit had numerous cards which contained no names, addresses, or social security numbers. The internal auditor and the audit committee board member reporting this noncompliance in a letter to the President, Mr. Munoz. Mr. Munoz stated that he then discussed this particular violation with the Executive Vice President and told him to see that it was corrected.

Our investigation of the card files involved determined that several large depositors were personal customers of Banco Financiero's marketing officer, and that their existence was unbeknownst to that officer's supervisor, the branch manager or the President, notwithstanding the fact that at least one of these customers could probably be catagorized as one of the bank's largest depositors.

We also uncovered an unusual situation at Banco Financiero and the Banco de Ponce involving the purchase of millions of dollars of manager's checks with what appear to be bad checks. We documented $1.7 million of these transactions at Banco Financiero during the period July 23, 1984 through October 30, 1984 though we did not review every day during this period. It appears that a courier delivered numerous $9,500 checks drawn by Rodal Magazine Distributors on another bank to Banco Financiero on a daily basis. Daily transactions ran as high as $150,000. The courier (with the help of a bank officer) would buy numerous manager's checks, payable to third parties. These checks were then redeposited the next day right back into the account of Rodal from which the funds were taken in the first place, thus covering the otherwise bad checks. These transactions were apparently given the blanket approval of Angel Alvarez, a board member with Banco Financiero.

During one week in April 1985, Rodal purchased over $1 million in managers checks from the Banco de Ponce, again using worthless checks drawn on another bank. The Banco de Ponce immediately detected the scheme and ended it. At this point we do not know the purpose of these transactions. It is clear however, that these transactions violated Banco Financiero's policies and were apparently conducted unbeknownst to the President of the Bank, Mr. Munoz.

Conclusion

Mr. Chairman, as I am neither a banker nor a bank examiner, I would hesitate to make final recommendations based upon our investigation of money laundering in Puerto Rico. However, I think we can suggest that perhaps those experienced in these fields could explore certain possibilities.

1. Our investigation of the daily teller's transactions immediately surfaced problems in several of the institutions we surveyed. We determined which days to review at any given branch by reviewing their cash transactions with their correspondent bank or the Federal Reserve. This surfaced unusual cash activities at particular branches on specific dates. Perhaps this same technique could be used by banks and their regulators in determining compliance with the currency reporting requirements of the Bank Secrecy Act.

2. It is virtually impossible for an internal auditor to audit large currency transactions in an institution that does not specifically record currency transactions on the teller's tape. On the other hand, institutions we reviewed which had on-line computer systems or which manually prepared cash in, cash out tickets, left very easy trails for internal audit to follow. Bank managers may wish to ensure that their systems leave a clear audit trail for currency transactions in order to further protect themselves from being victimized by money launders and their accomplices.

3. A significant number of the cases involved in Operation Tracer concerned officers who had the apparent authority to act alone in issuing bearer certificates or managers checks. The nature of these instruments would seem to dictate that two responsible officers should be involved in their issuance.

4. Several banks we reviewed issue certificates of deposit and manager's checks only to established customers. Manager's checks and certificates of deposit over specified amounts require full identification just as would be required in cashing a third party check. This is an extension of the "know your customer" policy such as that recently implemented by the Bank of Boston. This again, seems to be good insurance at little cost.

4. Several banks in Puerto Rico require daily currency analyses to be conducted by their operations officers at the branch level. This immediately identifies any unusual currency flows and alerts senior management to the possibility that these may be unreported. These banks view this additional step as sound cash management which goes hand in glove in determining the branch's daily cash needs, a process all banks must go through regardless.

In conclusion, it is our impression that though the Bank Secrecy Act has been a matter of widespread attention in some quarters of the Puerto Rican financial community, a few bankers and bank officers have caused a near calamitous situation in that community. The institutions involved have learned the painful lesson learned by so many before — that a careless approach to the Bank Secrecy Act can end in disaster. Our investigation indicates that all these situations could have been detected and quickly remedied with minimal amount of cost or effort on the part of the banks and their regulators.

Chairman ROTH. We are going to change the order and at this time call Mr. Schilling, the Director of Office of Examinations and Supervision, Federal Home Loan Bank Board; Vincent Cerreta, the former Acting Director, Federal Home Loan Bank Board, New York Regional Office; and Frank Nelson, Field Manager, Federal Home Loan Bank Board, New York Regional Office.

Gentlemen, if you would please raise your right hand. Do you swear the testimony you will give before this subcommittee will be the truth, the whole truth and nothing but the truth, so help you God?

Mr. SCHILLING. I do.

Mr. CERRETA. I do.

Mr. NELSON. I do.

Chairman ROTH. Please be seated. Mr. Schilling, if you would proceed.

TESTIMONY OF WILLIAM J. SCHILLING, DIRECTOR, OFFICE OF EXAMINATIONS AND SUPERVISION, FEDERAL HOME LOAN BANK BOARD, ACCOMPANIED BY VINCENT CERRETA, FORMER ACTING DIRECTOR, FEDERAL HOME LOAN BANK BOARD, NEW YORK REGIONAL OFFICE, AND FRANK NELSON, FIELD MANAGER, FEDERAL HOME LOAN BANK BOARD, NEW YORK REGIONAL OFFICE

Mr. SCHILLING. Thank you, Mr. Chairman, distinguished members of the subcommittee. I am William J. Schilling, Director of the Office of Examinations and Supervision of the Federal Home Loan Bank Board.

First, may I apologize to the subcommittee for Chairman Gray, who is unable to be here due to his prior commitment to appear this morning before the Senate Banking Committee. Second, appearing with me here today are Frank Nelson, the Field Manager, Federal Home Loan Bank Board from our New York Office and Vincent Cerreta, the former Acting Director of the New York Office.

I am here to testify today on the Board's efforts to carry out its responsibility under the Bank Secrecy Act. The Board has been reviewing its activities in order to explore the matter further and to take steps to strengthen its implementation of the Bank Secrecy Act responsibilities.

In my testimony, I will talk briefly about the Board and the Office of Examinations and Supervision. Then I will talk about our examinations process in general, the recent limitations the Board has faced due to serious staffing shortages, our Bank Secrecy Act procedures, our efforts with regard to the Puerto Rican institutions involved in Operation Tracer and our plans for strengthening our Bank Secrecy Act activities.

The Federal Home Loan Bank Board is the regulatory agency for all federally chartered thrift institutions. It shares with the States regulatory authority over those State-chartered thrifts whose deposits are insured by the Federal Savings and Loan Insurance Corporation.

The Office of Examinations and Supervision carries out the Board's responsibility for the examination and supervision of all institutions chartered by the Federal Home Loan Bank Board or insured by the Federal Savings and Loan Insurance Corporation. OES is charged with determining the financial safety and soundness of insured institutions, regulatory compliance and, particularly, with identifying those institutions that present an increased risk of loss to the Federal Savings and Loan Insurance Corporation.

The heart of the OES activities is the examination process. An examination is designed primarily to evaluate the safety and soundness of the association in question. The examination reviews not only financial matters, but also management capabilities and performance.

As I am certain that you are well aware, the examination process has become substantially more difficult in recent years. This is due in large part to three factors: the changing nature of thrifts themselves, the economic distress and losses suffered by virtually all thrifts in the late 1970's and early 1980's and our severe staffing limitations and retention problems.

In 1975, the typical thrift would have passbook accounts, time deposits, and certificates of deposit as its liabilities. It assets would have principally been residential mortgages secured by first loans. Today, liabilities include reverse repurchase obligations, equity participation certificates of deposit, convertible subordinated debt, money market deposit accounts, and an endless variety of other accounts. Assets are similarly more complex. In fact, some States have granted State-chartered thrifts virtually unlimited investment authority—from windmill farms, to Arabian race horses, wildcat oil explorations, and noninvestment grade junk bonds.

This increased complexity has occurred at a time of stress and weakness for the thrift industry. A prior witness testified as to the increase in strengths of deposits in 16 commercial banks in Puerto Rico. Clearly, the situation was different for the thrift industry. While the deposits for the thrift industries from 1975 to 1985 did, in fact, grow, you are well aware that the industry suffered severe losses during that period of time. The industry's net worth dropped from 6.9 percent of deposits in 1975 to 4.9 percent of deposits in 1985.

Mr. Chairman, more than 1,500 institutions that we regulate disappeared through consolidation or merger during that time frame.

[At this point in the hearing, Senator Rudman withdrew from the hearing room.]

[The letter of authority follows:]

U.S. Senate,
Committee on Governmental Affairs,
Senate Permanent Subcommittee on Investigations,
Washington, DC.

Pursuant to rule 5 of the Rules of Procedure of the Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, permission is hereby granted for the chairman, or any Member of the subcommittee as designated by the chairman, to conduct open and/or executive session hearings without a quorum of two Members for the administration of oaths and taking testimony in connection with hearings on "Money Laundering in Puerto Rico." These hearings are to be held on July 25, 1985.

Bill Roth,
Chairman.
Sam Nunn,
Ranking Minority Member.

Mr. SCHILLING. Moreover, in the 4 years from 1981 to 1985, the FSLIC has been forced to liquidate 21 institutions, more than 1½ times the number of liquidations in the entire preceding 47 years of the FSLIC.

These difficulties, Mr. Chairman, have taxed our examination and supervisory abilities to and beyond the limit.

Due to the staffing and salary restrictions, the examiner work force has not been able to keep pace with the growing demands on examiners. Until July 6, 1985, examiners were employees of the Federal Home Loan Bank Board and were subject to Office of Personnel Management and Office of Management and Budget restrictions. There were only 750 professional staff members and 120 clericals in our district offices across the entire United States.

This level of staff was and clearly is insufficient to handle the problems facing our industry, particularly in light of the changing nature of the industry and the literally hundreds and hundreds of thrifts which were and still are suffering severe financial difficulties.

Compounding the budgetary restrictions on staffing, was the Bank Board's inability to compensate adequately its examining staff through the civil service classification policies. In fact, Bank Board examiners were paid significantly less than their counterparts at the other financial federal regulatory agencies.

For fiscal year 1984, the field staff turnover rate was 16.1 percent nationwide. In 1985, 25 percent—one quarter—of our examiners have had less than 2 years of experience with the Bank Board. In the 18 months just ended June 30, 1985, 189 field employees have resigned. We have had to replace them. Unfortunately, this high turnover rate has resulted in less experienced staff to deal with the increasingly complex problems that we now face in a deregulated environment.

The problems of increasing examiner workload and loss of qualified examiners have been especially acute in our New York district, the Bank Board district that is responsible for examining and supervising institutions in the Commonwealth of Puerto Rico.

[At this point in the hearing, Senator Rudman reentered the hearing room.]

Mr. SCHILLING. In the New York district, FSLIC institutions grew from $57 billion in 1981 to $89 billion in 1985; and the responsibility for examining and supervising 13 federally chartered savings banks which are insured by the FDIC and have total assets of $37 million have been added to the New York district's caseload.

Despite this fact, the number of examiners in that district has dropped from 74 in 1981 to 62 in 1985. In New York, attrition has occurred particularly among our more senior examiners. In 1983, for example, we lost six of our more senior xaminers. In 1984, we lost an additional three senior examiners. The critical need for a larger and more experienced examination force was .recognized both by the congressional committee charged with oversight of financial regulators and with the Department of Treasury itself.

In 1984, the House Committee on Government Operations noted that the job of a bank examiner, including a savings and loan examiner, is becoming increasingly complex and demanding, and I would point out to the Senators that the Treasury Department, which is assigned primary responsibility under this act, has itself recognized our weakness. In its Federal deposit insurance report in 1985, the Treasury Department highlighted the Bank Board's critical need for additional examination and enforcement resources. This urgent need is heightened by additional responsibilities given to the Board by the Congress.

Over the years, the Congress has expanded the responsibility of the Board's examiners to include detecting violations of law which are not directly related to the financial health of the institutions that we examine. In fact, in addition to the basic legislation establishing the Board and its responsibilities, at least 15 statutes give examinations and/or enforcement authority to the Board.

Our critical shortage of examiners, particularly the most experienced examiners, has required the Board in recent years to employ less frequent examinations, to limit the scope of examinations and to concentrate attention on evaluating the safety and soundness of insured institutions.

In 1984, pursuant to a directive by the House Committee on Government Operations, the Bank Board established a task force on restructuring to study the options for improving the process of examination and supervision. The task force recommended to the Board that the examiners be made a part of the Federal Home Loan Bank system, pursuant to the provisions contained in the Federal Home Loan Bank Act.

The Board acted promptly on that recommendation. On July 6, 1985, the Board delegated its examination functions to the Federal Home Loan Banks. As of that date, former Bank Board examiners are employed by the Federal Home Loan Banks. In addition to increasing efficiency by bringing the examining and supervisory functions together, this restructuring should help ease the staffing crisis the Board has faced. Of course, the delegation of authority to the Federal Home Loan Banks took place only very recently, and it will take some time to build up examining staffs of the number and caliber that the Board so desperately needs.

The Bank Secrecy Act is a law addressed in examinations. The Treasury Department has the primary responsibility for the enforcement of the act but its regulations delegate to the Board the responsibility for assuring compliance by institutions whose accounts are FSLIC insured. OES has sent to each FSLIC insured institution and to all of our professional staff across the country Treasury Department publications, the forms institutions are required to file, a number of T or technical memoranda and a number of other communications.

We have advised the thrift industry and our professional staff of a number of amendments to the Bank Secrecy Act regulations, including their effect. T-53-7, dated May 23, 1985, reiterates the fundamental purpose of the Bank Secrecy Act and reminds institutions that management should establish training programs as well as operating procedures and compliance guidelines.

The Board's examination procedures were developed in conjunction with the Office of Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation in consultation with representatives of the Department of Treasury and the Government Accounting Office.

These Examination Objectives and Procedures—or EOP—are designed to test an institution's compliance with the regulations. Due to the financial crisis facing the thrift industry and of our lack of staff, the EOP's mandatory usage was suspended in 1982. But EOP examiner worksheets and Bank Secrecy Act checklists remain the principal guidance to examiners with regard to full-scale compliance examinations and the Bank Secrecy Act.

Whenever necessary, examiners have the responsibility to apprise institution management, particularly those of newly chartered or insured institutions, of their responsibilities under the Bank Secrecy Act regulations. The supervisory agents of the 12 Federal Home Loan Banks have the responsibility to take appropriate supervisory action necessary to obtain institution compliance. Reports of violations are transmitted to the Treasury Department. These reports include the identity of the institution, a description of the suspected violation and any corrective action.

In addition, OES may recommend to the Treasury Department imposition of civil penalties and may make referrals for possible criminal investigations regarding suspected Bank Secrecy Act violations.

At this point, I would like to briefly discuss our examinations of the four institutions which employed individuals recently charged with assisting in illegal money laundering activities.

Chairman ROTH. I am going to ask you to summarize.

Mr. SCHILLING. I think I can. Caribbean Federal Savings Bank was most recently examined as of March 1985. The examiner included a comment in the examination report which indicated the bank had filed only one form 4789 during the period covered by the examination, but a test check of deposit slips for a 2-month period disclosed 32 cash deposits which would have required a filing of form 4789.

The comment and response were revised by the field manager. Later the comments were deleted entirely from the final examination report by the Acting District Director based on information supplied by the association president claiming that the deposits were rollovers that did not require the filing of the forms.

These alterations in the examination reports have been referred to our Inspector General for investigation and recommendation. The original comments and responses are being reinserted. Perhaps, Mr. Chairman, it would be best if I go forward to the recommendations made by the agency for future activities.

It is very clear Chairman Gray takes great discomfort in what has been revealed by Operation Tracer and has reviewed these recommendations for the Bank Board. We are instructing the Bank System Office of Education to design and institute in its curriculum materials to adequately address money laundering, provisions in the Bank Secrecy Act and the examining procedures to be used to detect violations. We are going to request that immediately that office and our General Counsel's Office of Enforcement immediately prepare a video tape course for use by all of our professionals across the country. We will revise the Bank Secrecy Act section of the Bank Board's EOP as well as add a Bank Secrecy Act section to the new proposed supervisory objectives and procedures.

We will hold the management and board of directors of each institution responsible for maintaining fully documented internal controls and policies to ensure accurate, timely, and complete reporting.

We propose to require each institution to have its internal auditor during normal audit procedures periodically review and test compliance.

We will add requirements for the outside independent auditors to review and test compliance with the institution's system of internal controls and reporting. The results of that review will be reported to the Federal Home Loan Bank Board. We propose to require that every institution require a member of management to act as compliance officer and work with examiners regarding matters of the Bank Secrecy Act.

We will create a task force of senior OES accounting personnel whose purpose will be to consult the auditing standards executive committee of the American Institute of Certified Public Accountants in order to strengthen existing auditing standards.

We are considering instructing institutions to perform background checks on entities which claim to be exempt from filing under BSA compliance guidelines.

We also are considering instructing institutions to provide examiners with complete lists of currency transaction report filings and exemption lists prior to the examination.

We will expand our coordination efforts with the Treasury Department in the enforcement of the Bank Secrecy Act.

I have directed the Deputy Director of OES to issue a directive to all field personnel: where significant Bank Secrecy Act violations are discovered, an immediate interim report will be forwarded to supervision and the Treasury Department. If we do not have adequate personnel at the time to pursue the investigation, we will request the assistance of the Treasury Department. Thank you, Mr. Chairman.

Chairman ROTH. Mr. Schilling, as I indicated some time ago, I am really not satisfied with the explanations. Senator Rudman and I have sat here many a day, in this area and others. You can almost count on—without exceptions—the excuse or rationalization is we don't have enough personnel. I can't tell you how many times the Pentagon has come up here when we talk about private contractors. The whole problem is always that they don't have enough people. Frankly, many times the problem is they have too many people. So I don't accept that.

I am not saying you don't need additional people at this time or in the past, but I don't think that is an explanation of the unsatisfactory record we see here before us. And this goes way back. It is not something new.

Just let me go back to the record entered by the prior witness, Mr. Morley. It points out even as far back as 1980, in 1980 your institution examined 3,543 savings and loans and only found 14 violations, or less than 1 percent, 0.39. That same year, FDIC, 6,776; 497 violations, or 7 percent. Year in and year out, this is not just something that happened with deregulation under this administration. It predates it, and I would point out only two cases, the Federal Home Loan Bank Board has referred only two cases to Treasury since the passage of the Bank Secrecy Act. A small fraction of 1 percent of your examinations from 1980 to 1984 found violations, as I said, compared to the 15 percent of FDIC.

How can you explain this tremendous descrepancy?

Mr. SCHILLING. I think it is clear our procedures are that every time the Bank Secrecy Act is violated, and as I indicated up to 1982, this was part of the EOP, all of those violations are provided on a regular basis to the Treasury Department.

During this period of time in the history of the thrift institutions, clearly the institutions that we regulate were not largely engaged in the substantial cash-type transactions, although it did occur, that would be occasioned by commercial banks, nor do we have the foreign currency transactions that are occasioned by the commercial banks. It would simply, in my opinion, be less of that activity in the thrift——

Chairman ROTH [interposing]. I would emphasize in that period of time, you only referred two cases.

Mr. SCHILLING. Mr. Chairman, a correction. I think we made two recommendations for civil penalties. I believe that is correct. I think we did report, the other figure you cited were instances where we discovered some violation of the act. I believe that is correct.

Chairman ROTH. That is still less than 1 percent and certainly what other agencies have found make that look very suspect.

Let me ask you this question. What did your agency do when they suddenly discovered, or maybe they didn't discover, this tremendous flow of currency in Puerto Rico?

Mr. SCHILLING. The flow of currency that both you and Senator Rudman referred to is flow of currency, I believe, in the commercial banks. I do not know that that was the case. At this time in Puerto Rico, the savings and loan industry was in pretty dire straits. What was referred to there was flow of funds into commercial banking operations for which we do not examine or regulate.

Chairman ROTH. How did you handle form 919? How were they filled out in the examinations?

Mr. SCHILLING. The form 919 is supposed to be filled out by the examiners. It had come to my attention on a number of occasions it is provided to management to be filled out and then the examiner verifies the data. That is an incorrect procedure and will be corrected.

Chairman ROTH. My understanding is it was turned over and there was very little effort made to find out whether it was correct. How could this situation arise and you not discover it?

Mr. SCHILLING. In reviewing the circumstances of this operation and reviewing the procedure, I and my senior staff have looked into the procedure. We have an advance package which we have turned over to the institution and the institution is required in advance of the examination to prepare a substantial amount of information for us. Form 919 should not be done by the management of the bank; will not be done by the management of the bank.

Chairman ROTH. But to me that is a perfect example of the inadequacy of the examination. That is not caused by lack of adequate personnel; that is a problem of inadequate training and inadequate auditing of what people are doing.

Let me go to the testimony of Mr. Morley. He states this:

> During this March 1985 examination of the Caribbean, a Federal Home Loan Bank Board examiner requested copies of CTR's filed during the 30 preceding months. Caribbean produced one CTR. Given the rapid growth rate of Caribbean's balance sheet, the examiner suspected more CTRs should have been filed and, accordingly, expanded his examination. He found a large number of apparent cash purchases of certificates of deposit during December 1984 and 1985 in excess of $10,000 for which no CTRs are filed. The examiner described these in his draft of the final report of examination.

And that was reported, I believe, in the draft. Now, subsequently, Mr. Penagaricano, the president of Caribbean, protested to Vincent Cerreta—I believe Mr. Cerreta is here—former Acting Regional Director for the Federal Home Loan Bank Board in New York stating that he was sure that they could document that these transactions were, in fact, not currency transactions.

The president of Caribbean later submitted such alleged documentation for the month of January and February. The examiner comment regarding the failure to file CTR's was stricken from this record unbeknownst to the examiner.

How did this happen?

Mr. Schilling. The examination report goes through a series of management reviews before it is formally turned over to supervision to be issued to the institution with a supervisory letter. It is reviewed by the examiner's and immediate superior and then his superior for accuracy, correctness. It is not a common practice for an examination report to be changed, but if additional facts come to light, it is within the professional discretion of the superior officer to change it.

I would point out that that is one situation that we are moving to change and have moved to change beginning late last year. Our new policies will require that before a change can be made, we have to go back to the examiner in question before any substantive change can be made. We are adopting the same procedurse used by the Federal Reserve from, I believe, the Boston district.

Chairman Roth. We have Mr. Nelson here, I believe, don't we?

Mr. Nelson. Yes.

Chairman Roth. You were the bank examiner's supervisor. Mr. Morley has testified that the examiner's terminology regarding the bank's lack of understanding of exempt qualifications was inappropriate so he, meaning you, took what you term poetic license and struck the comments from the report; is that correct?

Mr. Nelson. Yes, Senator, but in this instance, I was also the examiner as well in a very real sense, as well as supervisor of the examiner because I was at Caribbean Federal. I was basically responsible for the drafting of this comment.

Chairman Roth. Did you ever talk to Mr. Penagaricano?

Mr. Nelson. No; I did not.

Chairman Roth. Then how could you add the statement that Mr. Penagaricano would ensure correction of any deficiency in the compliance area even though you have not spoken to him?

Mr. Nelson. Senator, I have a problem with this. Do you mind if I took this chronologically?

Chairman Roth. What is that?

Mr. NELSON. I have difficulty explaining that unless I take you through chronologically.

Chairman ROTH. Yes; please go through it chronologically.

[At this point in the hearing, Senator Gore entered the hearing room.]

Mr. NELSON. I was at the association; I asked the examiner in charge about the filings. He said they only had one. I advised him let's get the tickets. I went through basically advising him how to proceed in this area. We drafted a comment. The next day I left.

Now my next situation looking at this is reviewing it back in New York. I see that the managing officer's comment is not responsive to the comment and would tend to make a third party believe perhaps there wasn't a violation. I made an addition to the comment to strengthen it, but now I have a problem where I have somebody responding to a comment that he hasn't seen. Now we advised mangaging officers in all instances that comments are subject to editing and that their official response is the response to the supervisory letter. This is my reason for the editing.

Chairman ROTH. Well, let me ask you this. Rather than merely striking the statement, why didn't you say that the statement was erroneous?

Mr. NELSON. I should have, Senator. That would have been better judgment.

Chairman ROTH. As you said, you never talked to the president of Caribbean. Did the president of Caribbean have a position with the regional office?

Mr. SCHILLING. The president of Caribbean was the vice chairman of the Federal Home Loan Bank of New York. I think it is important for the committee to understand the structure.

The Federal Home Loan Bank of New York is our credit facility and is a membership organization. Part of its board of directors are public interest directors appointed by the bank board. The remainder of the directors are elected by the industry. In New York, the vice chairmanship rotates among the elected members in New York, New Jersey, and Puerto Rico based upon asset strength.

The bank side of the New York Bank is not involved in the supervisory side of the New York Bank, nor at that time was it in any way involved with the examination function.

Chairman ROTH. Let me go back. Who did the president of Caribbean contact on this matter?

Mr. CERRETA. He contacted me, Mr. Chairman.

Chairman ROTH. What did he tell you?

Mr. CERRETA. He called me after the examination was completed and said that he had gone over the comments with the examiner in charge and after the examination was completed, he went back to the, I think, it was the branch office—I am not sure—he went back to find out how there could be so many missing, so many cash transactions without form 4789. And he discovered that they were not cash transactions; they were rollovers of certificates of deposit. So I told him, you send documentation to support that up to me and I would review it and see whether the comment should be removed.

Chairman ROTH. As I recall, this documentation that was used to justify these are not for the correct 2 months?

Mr. CERRETA. The comments specified December 1984 and January 1985, I believe. What he sent me was January 1985 and February 1985. I compared all of the January transactions with what we had in our workpapers and they were rollovers of certificates of deposit and not cash transactions.

Chairman ROTH. But for the wrong period.

Mr. CERRETA. For the period of January, January compared perfectly.

Chairman ROTH. What about the other month?

Mr. CERRETA. I couldn't compare the other month——

Chairman ROTH [interposing]. Did you go back and ask him?

Mr. CERRETA. No, I didn't go back any further because 1 month checked out perfectly, and I felt he was justified in what he had said.

Mr. SCHILLING. I would point out, Mr. Chairman, clearly this procedure will not be permissible under operations of the Bank Board. It was an error in professional——

Chairman ROTH [interposing]. I assume it won't happen again, but how could it have happened in the first place? I mean, here you have your own examiners, a man of position of responsibility accepting an explanation of a man who has a conflict of interest. He was president of the Caribbean Bank and he was also, what, vice chairman of the regional board. What kind of instructions do you give to your Board with respect to their—do you have a number of people from banks, or savings and loans on the Board?

Mr. SCHILLING. Each bank has a board of directors which is comprised both of industry members and of public interest members. It is my understanding the public interest members are appointed by the Bank Board. The industry members are the result of an election. But, again, that Board, while it participates in the operation of the bank as a bank does not participate in and is not a part of the supervisory side of the bank. That is the Federal Home Loan Bank Board in Washington.

Chairman ROTH. Let me ask Mr. Cerreta, before deleting the Bank Secrecy Act comments from the report, did you discuss your intentions with either the examiner that wrote the examination report or the field manager who had previously reviewed and approved the draft report?

Mr. CERRETA. No, I did not.

Chairman ROTH. Why not?

Mr. CERRETA. I didn't think I had to. It's my position; I am responsible for the quality of that report and I prepared it in such a fashion that I believe it was accurate and that the examiner would see the results of my findings, of my work when he reviewed the report.

Chairman ROTH. Did your decision to delete the comments on the Bank Secrecy Act have anything to do with the fact the president of Carribean was also the vice president——

Mr. CERRETA [interposing]. Mr. Chairman, no.

Chairman ROTH. How long have you known him?

Mr. CERRETA. I would say maybe 15 years.

Chairman ROTH. Have you ever previously deleted a bank examiner's comment at the request of a bank president?

Mr. CERRETA. I did not remove it at his request.

Chairman ROTH. Have you ever deleted a bank examiner's comment at the request of a bank president?

Mr. CERRETA. Not at the request of a bank president.

Chairman ROTH. Of an official of the institution you are examining?

Mr. CERRETA. No, Mr. Chairman. When I remove a comment, it is because I have made a decision it should not be there.

Chairman ROTH. But you did remove——

Senator GORE [interposing]. Mr. Chairman, I don't want to interrupt. I just wanted to ask if this letter, this "Dear Vince" letter of April 18 is part of the record? I think it should be if it is not.

Chairman ROTH. Yes, it is.

Senator GORE. Thank you.

Chairman ROTH. But let me ask you again, you did remove or X-out these comments after contact with the president of the Caribbean?

Mr. CERRETA. Yes, sir; that's right.

Chairman ROTH. Can you point to any similar situation of that occurring before?

Mr. CERRETA. Of removing comments?

Chairman ROTH. Yes, or X'ing them out or modifying them.

Mr. CERRETA. That happens quite often.

Chairman ROTH. At the request of the institution?

Mr. CERRETA. No, after my review of the facts or the comment as it stands. I may decide that the comment is not worthy of being in a report.

Chairman ROTH. How often has a bank official called you in your service to ask the removal——

Mr. CERRETA [interposing]. Nobody has ever asked me to remove a comment. They have questioned——

Chairman ROTH [interposing]. How about requesting you to modify it?

Mr. CERRETA. They didn't ask me to modify it either.

Chairman ROTH. Did he say it was incorrect?

Mr. CERRETA. He stated that the comment was incorrect; that the information was not correct, and I told him to submit the documentation to support that.

Chairman ROTH. But in other cases, have you changed a comment after discussion with a bank official?

Mr. CERRETA. I'm not sure. I may have in the case of one or two associations, but I can't recall.

Chairman ROTH. When were those other occasions?

Mr. CERRETA. Oh, I can't remember. It would go over several years.

Chairman ROTH. Senator Rudman.

Senator RUDMAN. Mr. Cerreta, you say you have known Mr. Pengaricano for how long?

Mr. CERRETA. Must be 15 years.

Senator RUDMAN. In what capacity have you known him?

Mr. CERRETA. I first met him, I believe he was working as a bookkeeper or an auditor—I'm not sure—at United Federal in Puerto Rico. I was an examiner at the time.

Senator RUDMAN. Have you known him socially?

Mr. CERRETA. No, never socially.

Senator RUDMAN. Never been out with him socially?

Mr. CERRETA. Never.

Senator RUDMAN. Never visited him in Puerto Rico in any other way?

Mr. CERRETA. Never.

Senator RUDMAN. Our investigators tell us that the documents that you used to make your decision to delete comments, those documents consisted essentially of deposit slips and applications for certificates of deposit; is that correct?

Mr. CERRETA. No.

Senator RUDMAN. What else was there? What did you have in front of you?

Mr. CERRETA. What was submitted to me were the deposit slips which matched the deposit slips we had in our workpapers and withdrawal slips removing the money from the certificate of deposit to deposit into the new certificate.

Senator RUDMAN. But, in fact, you did not have the certificates of deposit in front of you or copies of them, did you?

Mr. CERRETA. I had just the withdrawal slips.

Senator RUDMAN. And you did not have any checks that were involved, if there were, in that transaction, did you?

Mr. CERRETA. If there were checks, they were not there; no.

[At this point in the hearing, Senator Gore withdrew from the hearing room.]

Senator RUDMAN. Exactly, you said there were no checks and then you corrected yourself because you are an examiner, you said if there were no checks, so the fact of the matter is anybody who wanted to phony up this documentation, I don't know if they did or didn't, you did not look behind the basic documents furnished to you which were not what is called in the audit world "primary documents," they were secondary documents.

Mr. CERRETA. I agree.

Senator RUDMAN. Isn't that correct?

Mr. CERRETA. Yes; I agree.

Senator RUDMAN. And based on that, you take this whole report which says, "The association prepared only one form 4789 during the 30-month period under review. However, a test check of the deposit slips in the months of December 1984 and January 1985 disclose 32 cash deposits of $10,000 or more, most of which appear to have been used to open savings certificates," and you strike that whole comment out based on documentation furnished to you by a bank officer of a secondary nature; is that correct?

Mr. CERRETA. That's correct.

Senator RUDMAN. Do you think that is good procedure, Mr. Cerreta?

Mr. CERRETA. I had no reason to question Mr. Penagaricano's furnishing of that information.

Senator RUDMAN. Well, aren't you supposed to question deviations from standard practice? Isn't that what your job was in New York?

Mr. CERRETA. As far as I was concerned, there was no deviation there.

Senator RUDMAN. Because he said there wasn't.

Mr. CERRETA. That's true.

Senator RUDMAN. Well, I think we have probably taken this as far as we can. It is my understanding an investigation at the inspector general's level is underway in your department on this issue.

Mr. SCHILLING. It is not in my department. It is independent of my department. It is the inspector general of the agency who is investigating the entire matter.

Senator RUDMAN. Mr. Chairman, I believe the committee will be interested in a copy of that report when it is concluded.

Chairman ROTH. Yes, we will request that.

Senator RUDMAN. Mr. Schilling, I want to go into your testimony for a moment. On page 12, you say,

> On the day following the Attorney General's announcement of the Puerto Rico indictments, the chairman directed the Board's office of inspector general to expeditiously investigate the performance of the Board's examination and supervision apparatus with respect to Bank Secrecy Act violations on the part of the thrift institutions involved. The inspector general contracted with Price Waterhouse to conduct the evaluation. An interim report of that independent public accounting firm supports our conclusion that we have attempted to ensure compliance with the Bank Secrecy Act to the extent of our resources. Although, recognizing that the Board is unable to uncover all possible violations—if I had written it, I would have said "any"—all possible violations of the Bank Secrecy Act without a major commitment of its resources, the report finds that the Board's actions were generally appropriate given the other problems it faces and responsibilities it must meet.

That is your statement.

[At this point in the hearing, Senator Roth withdrew from the hearing room.]

Senator RUDMAN. Before I get to the Price Waterhouse statement on which that is based, do you happen to know whether Price Waterhouse is a regular consultant to your agency?

Mr. SCHILLING. I am sure we have utilized them on prior occasions. I believe they were utilized in the Empire——

Senator RUDMAN [interposing]. Are they used on a regular basis by your agency?

Mr. SCHILLING. I can't answer that.

Senator RUDMAN. Do you know what the cost of this contract they have been hired to write this report is? Do you know how much that is going to cost your agency?

Mr. SCHILLING. No, sir; I do not.

Senator RUDMAN. Have no idea?

Mr. SCHILLING. That office is completely independent from me.

Senator RUDMAN. I would like that furnished for the record, the contract for Price Waterhouse.

I read your conclusion on page 12, and I would like you to explain to me, if you will, based on Price Waterhouse—let me read you the significant parts of what they say.

> The nature of the examination procedures generally carried out with respect to currency transactions could not reasonably be expected to provide assurance of compliance with the act and efforts significantly greater than those currently taken would be necessary to achieve such assurance.

Then they say in the next paragraph—I am not taking these out of context; I am reading the concluding sentence of each of these paragraphs.

> The examination procedures are not sufficient, however, to establish that an association is in substantial compliance with the reporting provisions of the act nor to detect intentional violations.

Then they go on to say,

> Examination files frequently contain insufficient documentation of work performed and related findings to support conclusions regarding the nature and adequacy of procedures which control the reporting of currency transactions.

And then they go on to say something we all agree with, "Compliance with the act has been a low priority issue to most examinations." And then after those five declarations, they write this and if you can explain it to me, after a lot of talk about how preliminary the work is and it's going to take some time to gain assurance everybody is in compliance, they say this:

> Consequently, at this stage in our investigation, we tend to believe that the level of effort expended in reviewing compliance with the act was generally appropriate under the circumstances.

Now that concluding sentence, and I am sure you have read this report more closely than I have—I read it this morning—totally baffles me because they make five findings that you weren't doing your job and then they say what you were doing was appropriate under the circumstances. Can you explain that to me?

Mr. SCHILLING. I think, Senator, if you look at my entire statement with regard to the responsibilities of the agency overall, particularly with regard to safety and soundness of a very distressed industry and the cases and caseloads we were handling, I think that is the grounds for basing that conclusion.

We have knowledge that we need to do more and have outlined to the committee steps we intend to take to do more. And it is our intention to do more. However, during this period of time, given the straits that the thrift industry has been in, which I am sure you are well aware of, our resources have been diverted to protecting the safety and soundness of the industry.

We diverted resources to Ohio; we diverted resources to Maryland; we have been forced to liquidate more institutions than we have ever had to handle in the past.

Senator RUDMAN. You heard our investigators say, Mr. Schilling, it took them a matter of minutes. Granted, they were only there for that purpose, but a matter of minutes to immediately determine there were serious problems with CTR reporting.

[At this point in the hearing, Senator Roth reentered the hearing room.]

Senator RUDMAN. I am not going to disagree that the savings and loan industry has had a lot of problems, and that your agency has a lot of work to do. I think that is a valid comment. But I would really appreciate a little candor occasionally from some Federal officials coming before us.

Would I be putting words in your mouth if I were to say that on reflection as the supervisor of this office that given all your problems that you could have done a somewhat better job than you did under the circumstances?

Mr. SCHILLING. I believe we could have done a better job. One of the things I have directed as a result of this situation is that resouces should not be an excuse. If we find violations, that matter will be immediately referred to the Department of Treasury. And we will consult with them as to whether they can provide the resources, we can provide the resources or some other agency can do it, and we will take that step, Senator; we will.

Senator RUDMAN. Well, Mr. Schilling, I am glad to hear that. The problem, of course, is that we generally find the regulators asleep at the switch. Then they come in and testify everything is going to be fine. Of course, you can understand the frustration of this committee. We pass laws and expect enforcement and then find they are not being enforced. I certainly hope your agency will do whatever it needs to do quickly, although I certainly have my suspicion that if we have a hearing on this subject next year, you will be back in here saying we just didn't have enough people. Thank you, Mr. Chairman.

Chairman ROTH. Thank you, Senator Rudman. Mr. Rinzel.

Mr. RINZEL. Mr. Nelson, is it fair to say you viewed the Caribbean matter as a serious matter involving a potentially serious violation of the Bank Secrecy Act?

Mr. NELSON. Yes; I would say so.

Mr. RINZEL. Did you recommend to your superiors that the case be referred to the Treasury Department for civil or criminal prosecution?

Mr. NELSON. I believe that is handled by the supervisory agent.

Mr. RINZEL. I take it the answer is you did not?

Mr. NELSON. I did not.

Mr. RINZEL. Did you recommend to the supervisory agent or to Mr. Cerreta that the supervisory agent transfer the matter or recommend civil or criminal penalties to the Treasury Department?

Mr. NELSON. I did not.

Mr. RINZEL. Why not?

Mr. NELSON. My understanding is that this decision is made on a higher level based on the report comments.

Mr. RINZEL. But you removed some of the comments that would provide information to the supervisory agent as to what the problem was in the Caribbean.

Mr. NELSON. I altered the response; that is correct.

Mr. SCHILLING. Mr. Rinzel?

Mr. RINZEL. How is the supervisory agent supposed to have the necessary information that would lead him to make such a recommendation?

Mr. NELSON. In this case, it may not have happened.

Mr. RINZEL. You did insert a statement in the report to the effect that the bank president would take corrective action; that's correct, isn't it?

Mr. NELSON. Yes, I did.

Mr. RINZEL. And you never had any conversation with the bank president, and he never made that statement to you; isn't that correct?

Mr. NELSON. That's correct.

Mr. RINZEL. And he never made the statement to Mr. Otto, the examiner either?

Mr. NELSON. I'm not certain about that.

Mr. RINZEL. But you have no knowledge that he did and you did not at the time that you attributed that comment within the report to the bank president, Mr. Penagaricano; you have no knowledge to this day that he ever said anything like that to anyone?

Mr. NELSON. That's correct.

[At this point in the hearing, Senator Rudman withdrew from the hearing room.]

Mr. RINZEL. Why did you put that statement in the report?

Mr. NELSON. Again, I have to go through chronologically. My problem was——

Mr. RINZEL [interposing]. We have heard that before. I don't think you need to go through it chronologically. The question is why you invented a statement that you attributed to a bank official to the effect he was going to correct the problem when he never made the statement?

Mr. NELSON. Because when I adjusted the comment, I had him responding to something which he hadn't seen——

Mr. RINZEL [interposing]. Did you assume he would say something like that if asked; is that right?

Mr. NELSON. In other words, I didn't want to give him any credit for not making violations but at the least everybody tells us we will correct the violations. In fact, I did call it a violation in my own terminology, which he was disputing.

Mr. RINZEL. Based on Mr. Cerreta's testimony, the bank president insisted there wasn't any violation, so why would he go about correcting it?

Mr. NELSON. I——

Mr. CERRETA [interposing]. Can I respond to that?

Mr. RINZEL. Surely.

Mr. CERRETA. He did contact me after the examination was completed. He may have at the time it was reviewed felt differently that there were violations that had to be corrected. I am not sure.

Mr. RINZEL. Well, he gave a phony explanation of what the law required to the bank examiner at the time of the examination; did he not?

Mr. CERRETA. Yes; that's right.

Mr. RINZEL. Didn't that concern you, Mr. Cerreta, as the acting regional director that one of your institution presidents and the vice chairman of the Federal Home Loan Bank of New York didn't understand what the law was in this area? In fact, he exhibited a gross lack of knowledge of what the law was?

Mr. CERRETA. Mr. Rinzel, as I had indicated in New York, when a comment has been revised, I don't often read the part that has been stricken out so I can't say that I even read his response at that time.

Mr. RINZEL. So you are going to lay that off on Mr. Nelson; is that right?

Mr. CERRETA. I'm just saying I didn't read that comment in its original form.

Mr. RINZEL. Did you consult with Mr. Nelson before making further additions and deletions in the draft report?

Mr. CERRETA. No, I did not.

Mr. RINZEL. Why was that?

Mr. CERRETA. Because I didn't feel that I had to.

Mr. RINZEL. Do you think it would have been wise for you to talk to the field manager who was actually in the bank and to the bank examiner who actually conducted the examination before making significant changes in their report?

Mr. CERRETA. No, I didn't think so because I had more information now than they had.

Mr. RINZEL. Apparently, you had less information than they had.

Mr. CERRETA. No, I had more. I had the withdrawal slips that they did not have.

Mr. RINZEL. Mr. Nelson, do you think it would have been wise to have been consulted before the further additional changes were made?

Mr. NELSON. In this circumstance, I do.

Mr. RINZEL. And if you had been aware that Mr. Cerreta was going to make these changes, would you have raised any concerns with him?

Mr. NELSON. In this circumstance, yes.

Mr. RINZEL. Are you aware that Mr. Otto, the examiner in Caribbean, asked to see Caribbean's exempt list and they were unable to provide one to him?

Mr. NELSON. No, I am not.

Mr. RINZEL. But, on the other hand, the form 919 that the bank officials filled out indicated they had an exempt list and this did not show up on any of Mr. Otto's comments or workpapers on the matter?

Mr. NELSON. I asked Mr. Otto for his concerns in this area, and he advised me there was only one transaction report filled out. At that point, I focused to determine where the transactions had occurred that should have triggered—it certainly seemed like there should be more forms filled out. At that point, he advised me this was his concern in that area, and I focused our efforts on trying to uncover some indications that more currency transaction reports should have been filed.

Mr. RINZEL. Does this whole scenario indicate to you and to the subcommittee the kind of general lack of attention that is paid by bank examiners of the Federal Home Loan Bank Board to the enforcement of the Bank Secrecy Act? You come across what are apparently serious violations; you do a limited check on them; you removed some of the comments; your supervisor removes the rest of the comments and nobody higher up in the organization ever finds out that there is even a problem until somebody gets arrested a couple of weeks after the examination.

Mr. NELSON. Senator, this was not a good performance.

Mr. RINZEL. I have no further question, Mr. Chairman.

Chairman ROTH. I have no further questions. Thank you, gentlemen.

[Mr. Schilling's prepared statement, with some attachments, follows. Other attachments to the prepared statement of Mr. Schilling may be found in the subcommittee files.]

STATEMENT OF
WILLIAM J. SCHILLING
DIRECTOR OF THE
OFFICE OF EXAMINATIONS
AND SUPERVISION
OF THE
FEDERAL HOME LOAN BANK BOARD
BEFORE THE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
OF THE
COMMITTEE ON GOVERNMENTAL AFFAIRS

U.S. SENATE
JULY 25, 1985

Mr. Chairman and distinguished members of the Subcommittee, I am William J. Schilling, Director of the Office of Examinations and Supervision of the Federal Home Loan Bank Board.

I am here to testify today on the Board's efforts to carry out its responsibilities under the Bank Secrecy Act. Operation Tracer, the federal money-laundering probe in Puerto Rico, recently led to the indictment of officials in institutions that the Board regulates. The Board has been reviewing its activities in order to explore the matter further and to take steps to strengthen its implementation of Bank Secrecy Act responsibilities.

In my testimony, I will talk briefly about the Board and the Office of Examinations and Supervision. Then I will talk about our examination process in general, our Bank Secrecy Act procedures, recent limitations the Board has faced due to serious staffing shortages, our efforts with regard to the Puerto Rican institutions involved in this case, and our plans for strengthening our Bank Secrecy Act activities.

The Federal Home Loan Bank Board

The Federal Home Loan Bank Board is an independent agency of the federal government. It is the regulatory agency for all federally chartered thrift institutions and is responsible for the enforcement of the Federal Home Loan Bank Act of 1933, the Home Owners' Loan Act of 1934, and the National Housing Act. It shares with the states regulatory authority over those state chartered thrifts whose deposits are insured by the Federal Savings and Loan Insurance Corporation.

The Office of Examinations and Supervision carries out the Board's responsibility for the examination and supervision of all institutions chartered by the Federal Home Loan Bank Board or insured by the Federal Savings and Loan Insurance Corporation. OES is charged with determining the financial safety and soundness of insured institutions, regulatory compliance, and, particularly, for identifying those institutions that present an increased risk of loss to the FSLIC.

Examinations

The heart of OES activities is the examination process. An examination is designed primarily to evaluate the safety and soundness of the association. The examination reviews not only financial matters, but also management capabilities and performance.

The examination process is substantially more difficult today than in earlier years because of the increasingly complex array of assets and liabilities held by thrifts. In 1975, the typical thrift would have passbook accounts, time deposits and certificates of deposit as its liabilities. Its assets would principally have been residential mortgages secured by first liens. Today, liabilities can include reverse repurchase obligations (reverse "REPOs"), equity participation certificates of deposit, convertible subordinated debt, money market deposit accounts and an endless variety of other accounts. Assets are similarly more complex. In fact, some states have granted state-chartered thrifts virtually unlimited investment and authority -- from windmill farms, to Arabian racehorses, wildcat oil explorations and noninvestment grade ("junk") bonds.

This increased complexity has occurred at a time of stress and weakness for the thrift industry. The deposits of the thrift industry grew from $278 billion in 1975 to $801 billion in 1985, but the industry's net worth dropped from 6.9 percent of deposits in 1975 to 4.9 percent in 1985. More than 1500 institutions have disappeared through consolidation and merger since 1975. Moreover, in the four years from 1981 to 1985 the FSLIC has liquidated 21 institutions, 1.6 times the number of liquidations in the entire 47 preceding years of FSLIC. These difficulties have taxed our examination and supervisory capabilities to the limit.

In addition, in recent years, the Congress has expanded the responsibilities of the Board, and consequently those of its examiners, for detecting violations of laws, many of which are not directly related to the financial health of the institutions we examine. For example, examiners now check for compliance with the requirement that lenders provide home buyers with advance disclosure of real estate costs (the Real Estate Settlement Procedures Act). Examiners must check the accuracy of complex disclosures to borrowers with regard to the annual percentage rates of their loans (the Truth In Lending Act). They must check for compliance with statutes that prohibit lenders from discriminating against borrowers because of their race, religion, or sex (the Fair Housing Act and the Equal Credit Opportunity Act). And they must examine for the protection of the rights of customers who use automated teller machines (the Electronic Fund Transfer Act). Further, examiners check for compliance with the Fair Credit Billing Act, the Fair Debt Collection Act, and the Community Reinvestment Act. In fact, in addition to the basic legislation establishing the Board and its responsibilities, at least 15 statutes (Exhibit 1) give examination and/or enforcement responsibilities to the Board.

The Bank Secrecy Act

The Bank Secrecy Act (BSA), which is designed to provide a paper trail of activities of money launderers serving white collar and organized crime, is also a law addressed in Board examinations. The Treasury Department has the primary responsibility for the enforcement of the Act but its regulations delegate to the Board the responsibility for assuring compliance by institutions whose accounts are FSLIC-insured. In July 1972, OES sent to each FSLIC-insured institution and our professional staff across the country a Treasury Department publication (Exhibit 2), which includes the BSA statute, regulations, and the forms that institutions are required to file under certain circumstances (e.g., currency transactions in excess of $10,000). Subsequently, by the issuances of "T", or technical, memoranda (#T 53 through #T 53-7, Exhibit 3) and other communications to our staff and the industry (Exhibit 4), we have advised the thrift industry and our professional staff of a number of amendments to the BSA regulations including the effect of and an explanation of the amendments. Our most recent "T" memorandum, #T 53-7, dated May 23, 1985, reiterates the fundamental purpose of the BSA and reminds institutions that management should establish BSA training programs as well as operating procedures and compliance guidelines.

The Board's examination procedures were developed in conjunction with the Office of Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation and in consultation with representatives of the Treasury Department and the Government Accounting Office. These Examination Objectives and Procedures (EOP) are designed to test institution's compliance with the BSA regulations and are divided into minimum scope and expanded scope procedures. The EOP's mandatory usage was suspended in 1982, but the EOP, Examiner Worksheets, and Bank Secrecy Act check list remained the principal guidance to field examiners with regard to full scale compliance examinations and the Bank Secrecy Act. (The procedures, Worksheet and check list are attached as Exhibit 5.) For example, the New York District advised its staff of its responsibility to continue to meet examination objectives (Exhibit 6).

Whenever necessary, examiners have the responsibility to apprise institution management, particularly those of newly chartered or insured institutions, of their responsibilities under the BSA regulations. The Board's Supervisory Agents at the twelve Federal Home Loan Banks have the responsibility to take appropriate supervisory action necessary to obtain institution compliance with their requirements (SP-31, Exhibit 7).

Reports of any suspected violations are transmitted twice a year to the Treasury Department. Included in the Board's report to Treasury is the identity of the institution where a suspected violation occurred, a description of the suspected violation and corrective action promised or already taken by the institution.

The BSA statute and regulations authorize the Treasury Department to assess a savings institution and any partner, director, officer or employee thereof a civil penalty for any violation of the BSA. The statute and regulations also provide for the imposition of a criminal penalty by the United States District Courts. OES may recommend to the Treasury Department the imposition of civil penalties and may make referrals for possible criminal investigation regarding suspected BSA violations. The Treasury Department has provided us with guidelines for making such recommendations and referrals (Appended to SP-31, Exhibit 7).

Resource Limitations

Due to staffing and salary restrictions, the size of the Board's examiner workforce has not been able to keep pace with the growing demands on examiners. Until July 6, 1985, examiners were employees of the Federal Home Loan Bank Board subject to Office of Personnel Management and Office of Management and Budget (OMB) restrictions. There were 750 professional staff members and 120 clericals in our District Offices, which were responsible for all examinations. This level of staff was and is clearly insufficient to handle the current problems facing the industry, which consists of over 3,000 institutions.

Compounding the non-self-imposed budgetary restrictions on staffing was the Bank Board's inability to compensate adequately its examination staff due to civil service classification policies. In fact, Bank Board examiners were paid significantly less than their counterparts at the other federal financial regulatory agencies. More specifically, the Bank Board's average examiner salary was approximately $25,000, which was $6,000 less than that of the Office of the Comptroller of the Currency, $8,000 less than the Federal Deposit Insurance Corporation and $13,000 less than the Federal Reserve Board. We believe that this fact contributes to the high turnover in the recent past among Bank Board experienced examiners.

For fiscal year 1984, the field staff turnover rate was 16.1 percent nationwide. In 1985, 25 percent of our examiners had less than two years experience with the agency. In the 18 months ended June 30, 1985, 189 field employees resigned. Unfortunately, this high turnover rate has resulted in a less experienced staff to deal with the increasingly complex problems which we now face in a deregulated environment.

The problems of increasing examiner workload and loss of qualified examiners have been especially acute in our New York District, the Bank Board District that is responsible for examining and supervising institutions in the Commonwealth of Puerto Rico. In the New York District, there has been a 57 percent increase in the total amount of assets of FSLIC-insured institutions since 1981 (from $56.9 billion in 1981 to $89.1 billion in 1985). In addition, since 1981, the Board's New York District has taken on the responsibility of examining and supervising 13 federally chartered savings banks which are insured by the Federal Deposit Insurance Corporation and have total assets of $37.3 billion. Despite this, there has been a 16 percent decrease in the number of examiners (from 74 in 1981 to 62 in 1985). Thus, in 1981 in our New York District, we had one examiner for every $768 million in assets to be examined. In 1985, we had only one examiner for every $1.4 billion in assets to be examined.

In New York, attrition has occurred particularly among our more senior and qualified examiners. In 1983, for example, we lost six of our most senior field examiners and in 1984, we lost three additional senior examiners.

The critical need for a larger and more experienced examination force was recognized by both the Congressional committee charged with oversight of the financial regulators and by the Department of the Treasury. In its report on Criminal Misconduct and Insider Abuse, H.R. Rep. No. 98-1137, 98th Cong., 2d Ses. 51 (1984) the House Committee on Government Operations ("the Barnard Committee") noted that the job of a bank examiner has become increasingly complex and demanding. In addition, the Barnard Committee noted that the supervisory agencies -- especially the Federal Home Loan Bank Board, which is constrained by the staffing, administrative and budgetary requirements of the Office of Management and Budget and other Executive branch agencies -- suffer from high turnover from low pay scales, difficult working conditions, personnel cutbacks and increased workloads.

The Treasury Department, in its Federal Deposit Insurance Report (January, 1985), also highlighted the Bank Board's critical need for additional examination and enforcement resources. The report echoed the Barnard Committee's concern by stating that "... Developing a large cadre of trained, capable, and experienced examiners, liquidators, and supervisory personnel is a slow process, constrained in part by the jobs' mobility requirement, government pay scales relative to private industry, and pressures to reduce the size of the federal workforce." Moreover, the report continued, "... given the current conditions of the ... thrift [industry], substantial demands on the [agency's] staff should continue for some time ...." The Treasury Department specifically recommended authorizing the Board to augment examination, supervision, and enforcement staff on a priority basis.

This critical shortage of examiners, particularly the most experienced examiners, required the Board to employ less frequent examinations, to limit the scope of many examinations, and to concentrate its primary attention on evaluating the safety and soundness of insured institutions.

Pursuant to a directive from the House Committee on Government Operations to examine the problems inherent in the "split" in authority between the field examiners of OES and the supervisory staff of the Federal Home Loan Banks, the Bank Board established a Task Force on Examination-Supervision Restructuring to study options for improving the process of examination and supervision coordination and communication. The Task Force recommended to the Board that field examiners be made a part of the Federal Home Loan Bank System, pursuant to provisions contained in the Federal Home Loan Bank Act and the Garn-St Germain Act.

The Board acted promptly on that recommendation and on July 6, 1985, the Board delegated its field examination functions to the Federal Home Loan Banks. As of that date, the former Board examiners are employed by the Federal Home Loan Banks. In addition to increasing efficiency by bringing the examination and supervisory functions together, this restructuring should help ease the staffing crisis the Board has faced. Of course, the delegation of authority to the Federal Home Loan Banks took place only very recently, and it will take them some time before they can build up examining staffs of the number and caliber that the Board has so badly needed.

Even though the Board has been faced with problems of understaffing, turnover, and a responsibility to oversee the administration of a broad range of federal laws, the Board has been committed to carrying out its Bank Secrecy Act responsibilities. It has attempted to ensure compliance with the Bank Secrecy Act to the extent of its resources.

The Board's Bank Secrecy Act Activities in Puerto Rico

At this point, I would like to briefly discuss our examination activities regarding the four institutions regulated by the Bank Board which employed individuals recently charged with assisting in illegal money laundering activities.

Caribbean Federal Savings Bank

This institution was most recently examined as of March 11, 1985. The examiner included a comment in the examination report which indicated that the bank had filed only one Form 4789 during the examination review period. He further indicated that a test check of deposit slips for a two month period disclosed 32 cash deposits which would have required the filing of Forms 4789, but for which forms were not filed.

The examiner's comment was deleted from the examination report by the Acting District Director based on information supplied by an association officer purporting to explain that the deposits were roll-overs that did not require the filing of Forms 4789. After this officer was indicted, it was determined that no reliance should be placed on his prior explanation, and the comment was restored to the final examination report.

Western Federal Savings Bank

This institution was last examined as of January 3, 1984. A number of BSA violations were noted and reported by the examiner. The examiner also reported that the institution had failed to respond to correspondence from the Treasury Department concerning violations of the Act. However, the examination review did not include the period during which the alleged illegal money laundering activities are said to have occurred. The portion of the examination report discussing the violations was forwarded to the Department of the Treasury.

First Federal Savings Bank

This institution was last examined as of October 1983, as a result of critical financial problems. Therefore, the examination was limited to financial issues and did not cover the Bank Secrecy Act. The last full examination was made as of May 17, 1982. No violations of the Bank Secrecy Act were noted in that examination.

Bayamon Federal Savings and Loan Association

Examiners noted deficiencies, along with the association's steps toward corrective action, with regard to Bank Secrecy Act compliance in the examinations of September 3, 1982, and September 9, 1983. The institution was last examined as of April 29, 1985. No violations of the Bank Secrecy Act were noted by the examiners.

As a result of the facts made available following Operation Tracer, the Board has taken certain actions. First, the Board issued suspension and prohibition orders for all seven employees of the Puerto Rico institutions who were indicted in connection with Operation Tracer.

Second, on the day following the Attorney General's announcement of the Puerto Rico indictments, the Chairman directed the Board's Office of Inspector General to expeditiously investigate the performance of the Board's examination and supervision apparatus with respect to Bank Secrecy Act violations on the part of the thrift institutions involved (Exhibit 8). The Inspector General contracted with Price Waterhouse to conduct the evaluation. An interim report (Exhibit 8) of that independent public accounting firm supports our conclusion that we have attempted to ensure compliance with the Bank Secrecy Act to the extent of our resources. Although, recognizing that the Board is unable to uncover all possible violations of the Bank Secrecy Act without a major commitment of its resources, the report finds that the Board's actions were generally appropriate given the other problems it faces and responsibilities it must meet.

Steps for Future Improvement

I do not want to mislead you into erroneous expectations as to the Board's capabilities with regard to the Bank Secrecy Act. Therefore, I believe that it is important to stress that the Board is not a criminal investigation agency. However, the fact that examiners cannot and should not be expected to collect all the evidence necessary for criminal investigations does not obviate the need for the Office of Examinations and Supervision to adopt a stronger program of examination and supervision under the Bank Secrecy Act. We believe that stronger actions can and should have a deterrent effect on those who might be tempted to use the thrifts we regulate for money-laundering operations. More strenuous efforts on our part would make it more difficult for money laundering to be accomplished through the thrifts we regulate, and we are firmly committed to undertaking the actions necessary to strengthen our program.

We expect Price Waterhouse to recommend actions for us to take to improve our regulatory process and ensure that these problems will not recur in the future. In addition, we have reviewed our existing policies and procedures and are in the process of significantly revising them in order to ensure more vigorous compliance by institutions. Regardless of the recommendations Price Waterhouse makes, we are taking specific actions in the following areas:

Examiner Training

We are instructing the Bank System Office of Education to design, and institute in its curriculum, materials to address the specific issue of money laundering. These materials will focus on the provisions of the Bank Secrecy Act and the subsequent examining procedures used to detect violations. We will also request the Bank System Office of Education and the Office of General Counsel's Enforcement Division to prepare a videotaped refresher course for use by supervisory and examinations staff throughout all twelve Federal Home Loan Bank Districts.

Examination and Supervisory Procedures

The Bank Board's Examination Objectives and Procedures manual is currently being updated, and we plan to revise our section on the Bank Secrecy Act. Realistically it would be impossible for the examination staff to check even one percent of the billions and billions of deposit and withdrawal slips and teller tapes necessary to verify the information presented to them by the insured institutions. However, the new EOP section on the Bank Secrecy Act will require examiners to review a random sample of cash deposits for compliance with that Act. We anticipate that the steps the Board has taken to lessen our problems of understaffing and employee turnover will give us the resources to permit more probing examination for compliance with the Bank Secrecy Act. A section on the Bank Secrecy Act will also be placed in the Supervisory Objectives and Procedures manual, which is currently under development.

Internal Control Requirement

We propose to require institutions to maintain a fully documented system of internal controls and policies detailing specific responsibilities and procedures to ensure accurate, timely and complete reporting under the "laundered money" statutes. This requirement would be the direct responsibility of the management and board of directors of each institution.

Internal System Review

We propose to require each institution to have its internal auditor, on a periodic basis, and in conjunction with its normal audit procedures, review and test compliance of the institution's system of controls and reporting procedures under the BSA statutes and report the findings to the board of directors.

Annual Audit Verification

We will add requirements to Bulletin PA-7a (Institution's Audit Requirement) instructing the independent auditors to review the institution's system of internal controls and policies relating to "laundered money" reporting and test compliance with such controls and policies. The results of such a review and test of compliance would be reported to the Federal Home Loan Bank Board in the form of a special report as prescribed by Statement of Auditing Standards No. 14 (as amended) Special Reports.

Institution Compliance Officers

We propose to require that every institution appoint a member of management to act as a compliance officer and work with examiners regarding matters relating to the Bank Secrecy Act.

Consultation with the American Institute of Certified Public Accountants

We will create a task force comprised of senior OES accounting personnel whose purpose it will be to consult with the Auditing Standards Executive Committee of the American Institute of Certified Public Accountants in order to strengthen existing auditing standards and formulate new procedures for future application.

Exemption List Checks

We are considering instructing institutions to perform background checks on entities which are exempt from filing under BSA compliance guidelines.

Advance Information

We are considering instructing institutions to provide examiners with complete lists of Currency Transaction Report filings and exemption lists prior to the examination.

Interagency Cooperation

We will expand our coordination efforts with Treasury Department officials in order to increase the flow of information going to financial regulatory agencies, such as the Federal Home Loan Bank Board, regarding the exchange of information on actions taken and investigations performed pursuant to the Bank

Secrecy Act. In addition, we will direct our Principal Supervisory Agent in each Federal Home Loan Bank District to coordinate with the appropriate Federal Reserve Board District(s) in order to monitor significant net cash flows that might indicate the need for examiner or Supervisory Agent follow-up.

I hope that the facts I have presented today clarify our concerns as well as our firm commitment to carry out our responsibilities under the Bank Secrecy Act.

Exhibit 1

Statutes, in Addition to the Federal Home Loan Bank Act, the Home Owners' Loan Act, and the National Housing Act, that are Administered or Enforced by the FHLBB

LAW	U.S.C.	REGS.	PURPOSE
Bank Protection Act	12 U.S.C. 1881-1884	12 C.F.R. 563a.1	Requires federal financial regulatory agencies to promulgate rules establishing minimum standards for installation, maintenance, and operation of security devices.
Real Estate Settlement Procedures Act	12 U.S.C. 2601-17	24 C.F.R. 3500	Provides for advance disclosure of settlement costs to home buyers and sellers; limits the amount home buyers are required to place in escrow accounts for payment of real estate taxes and insurance.
Home Mortgage Disclosure Act	12 U.S.C. 2801-11	12 C.F.R. 203	Requires regulated depository institutions which make "federally-related" mortgage loans to compile and make available for public inspection data on the number and total dollar amount of mortgage loan originated or purchased by each institution.
Community Reinvestment Act	12 U.S.C. 2901-05	12 C.F.R. 563e	Requires each federal financial supervisory agency to use its authority when examining financial institutions, to encourage such institutions to meet the credit needs of the local communities in which they are chartered consistent with save and sound operations.

LAW	U.S.C.	REGS.	PURPOSE
Depository Institution Management Interlocks Act	12 U.S.C. 3201-08	12 CFR 563f	Prohibits a management official of a depository institution from serving as a management official of another non-affiliated depository institution under specified circumstances.
Depository Institutions Deregulation and Monetary Control Act of 1980	codified throughout Title 12		Establishes the Depository Institutions Deregulation Committee to prescribe rules for the orderly phase-out and ultimate elimination of interest rate limitations. Extended federal override of state usuary ceilings on certain mortgage and other loans. Authorized NOW Accounts. Gave FSLIC authority to vary reserve requirements between 3% and 6%.
Federal Trade Commission Act	15 U.S.C. 57a		Directs federal financial regulatory agencies to establish a separate division of consumer affairs to resolve complaints of deceptive or unfair practices.
Securities and Exchange Act of 1934	15 U.S.C. 78l(i)	12 C.F.R. 552, 563b 563d, 569	Delegates the administration and enforcement of specific sections of the '34 Act pertaining to the registration of securities by insured institutions to the federal financial regulatory agencies.

LAW	U.S.C.	REGS.	PURPOSE
Truth in Lending Act	15 U.S.C. 1607	12 C.F.R. 226	Requires creditors to clearly state the terms and conditions of finance charges in credit sales, loans, open-end credit plans and credit advertising to enhance consumer understanding of available credit terms.
Fair Credit Billing Act	15 U.S.C. 1666-66j		Sets forth specific requirements a creditor must fulfill when written notice is received from an obligor disputing some or all of an account balance.
Fair Credit Reporting Act	15 U.S.C. 1681		Requires that consumer reporting agencies adopt reasonable procedures to provide fair and equitable reporting of consumer information to ensure confidentiality, accuracy, relevancy and proper utilization of such information.
Equal Credit Opportunity Act	15 U.S.C. 1691-91e	12 C.F.R. 202	Prohibits discrimination in lending on the basis of sex, marital status, race, religion, national origin, age, receipt of income from public assistance programs or because the applicant has good faith exercised any right under the Consumer Credit Protection Act.

LAW	U.S.C.	REGS.	PURPOSE
Fair Debt Collection Practices Act	15 U.S.C. 1692		Limits the manner and type of information which can be disclosed about a consumer. Prohibits harassment or abuse, false or misleading statements and other unfair practices.
Electronic Fund Transfer Act	15 U.S.C. 1693-93r	12 C.F.R. 205	Establishes the rights, liabilities and responsibilities of participants in electronic fund transfer systems. Designed to protect individual consumer engaging in electronic transfers.
Fair Housing Act	42 U.S.C. 3601-31	24 C.F.R. 105 12 C.F.R. 528, 531	Prohibits discrimination based on race, color, religion, sex and national origin in the sale or rental of housing, financing of housing, or the provision of housing brokerage services.
Flood Disaster Protection Act	42 U.S.C. 4012a	12 C.F.R. 523.29	Prohibits federally regulated lending institutions from making, increasing, extending, or renewing any loan secured by improved real estate or a mobile home located or to be located in a flood hazard area of a community participating in the National Flood Insurance Program unless the property securing the loan is covered by flood insurance.

Exhibit 3

FEDERAL HOME LOAN BANK BOARD

INTERIM REPORT

EVALUATION OF REGULATORY ACTIONS AND PROCEDURES IN CONNECTION WITH POSSIBLE VIOLATIONS OF THE CURRENCY AND FOREIGN TRANSACTION REPORTING ACT BY FOUR SAVINGS INSTITUTIONS IN PUERTO RICO

Price Waterhouse

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1801 K STREET, N.W
WASHINGTON, DC 20006
[illegible]

July 22, 1985

Mr. Paul F. Gibbons
Inspector General
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

Dear Mr. Gibbons:

We are in the process of conducting an evaluation of regulatory actions and procedures with respect to Currency and Foreign Transaction Reporting Act ("the Act") violations on the part of four savings institutions in Puerto Rico: Bayamon Federal Savings and Loan Association, Caribbean Federal Savings Bank, First Federal Savings Bank and Western Federal Savings Bank.

To date, we have reviewed documents related to the Act which have been identified from relevant examination files by FHLBB staff members in New York. We have also interviewed all available examiners-in-charge and assistant examiners who conducted work related to the Act in the two most recent examinations of the four subject institutions. (Our inquiry has generally been limited to the two most recent examinations due to record retention practices of the examination division, which discards all but the two most recent examination files.) We have begun our review of OES correspondence files and audit reports and internal control memoranda issued by independent accountants for the four associations since January 1, 1980. Pursuant to your request, we have developed the following preliminary observations:

The nature of the examination procedures generally carried out with respect to currency transactions could not reasonably be expected to provide assurance of compliance with the Act, and efforts significantly greater than those currently undertaken would be necessary to achieve such assurance.

The examination procedures employed have been comprised principally of inquiry of association personnel and review of copies of Currency Transaction Reports (IRS Form 4789) on file. Such procedures are sufficient to determine that an awareness on the part of association management of the Act's provisions exists, that procedures designed to achieve compliance have been developed, and that Currency Transaction Reports are prepared for some transactions. The examination procedures are not sufficient, however, to establish that an association is in substantial compliance with the reporting provisions of the Act, nor to detect intentional violations.

The effectiveness of an association's policies and procedures in achieving the goals for which they were designed can only be established by conducting detailed tests to determine that the policies and procedures have been properly implemented and are functioning as designed. Tests necessary to establish such circumstances have generally not been a part of examination scope.

Examination files frequently contain insufficient documentation of work performed and related findings to support conclusions regarding the nature and adequacy of procedures which control the reporting of currency transactions.

While checklists and examination programs were generally present and completed in the examination files we have reviewed, explanatory comments regarding the nature of association policies, procedures and compliance efforts were not evident in the files. The absence of such explanatory documentation makes a retrospective assessment of the adequacy of the procedures in place to assure compliance with the Act, and of the examiners' efforts and conclusions, impossible.

Compliance with Act has been a low priority issue in most examinations.

Within the context of the Bank Board's overall regulatory responsibility, currency transactions and compliance with the Act have generally been relatively minor considerations in most examinations. Asset quality, net worth and operating results have, appropriately, been the principal concerns during a period when the viability of many associations has been questionable and examination staff resources have been fully utilized in responding to major issues of safety and soundness.

Despite the existence of examination and supervisory problems of urgent concern, inquiries with respect to procedures for compliance with currency reporting regulations were uniformly made in routine examinations. In addition, Currency Transaction Reports (IRS Form 4789) on file were reviewed and deficient Reports which had been forwarded to OES by Treasury officials were followed-up to determine that corrections had been made by the associations.

We have formed a preliminary conclusion that the level of emphasis placed on compliance with the Act was appropriate under the circumstances.

* * * * *

Our work is in a preliminary stage at this time, and substantial portions of our work plan have yet to be undertaken. Consequently, the results of future work may have significant impact on the preliminary observations presented above. It is clear at this time, however, that to gain assurance that an association is in compliance with the Currency and Foreign Transaction Reporting Act would require an expenditure of effort by the examination staff far in excess of that currently applied in a routine examination. However, we question whether any realistic level of effort could be relied upon to detect instances of intentional non-reporting where the participation of association management is involved. Consequently, at this stage in our investigation, we tend to believe that the level of effort expended in reviewing compliance with the Act was generally appropriate under the circumstances.

Yours very truly,

James F. [illegible] III

Federal Home Loan Bank Board

EDWIN J. GRAY
CHAIRMAN

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

JUN 6

To: Paul Gibbons
Inspector General

From: Chairman Gray

Re: Puerto Rico S&L Investigation

I would like you to expeditiously investigate the performance of the Bank Board's examination and supervision apparatus in connection with the Federal investigation of narcotics money laundering through a number of savings institutions in Puerto Rico (see attached press release).

In the course of your investigation, please determine the role of examiners in this case in finding violations of the currency reporting requirements.

cc: Ann Fairbanks
Norm Raiden
Bill Schilling
Bryce Curry

Attachment

Chairman ROTH. Our next panel will be Antonio Munoz, chairman and CEO of the Banco Financiero de Puerto Rico and Jose Dumont, chief executive officer of Caribbean Federal Savings & Loan.

Gentlemen, if you will please raise your right hand. Do you swear the testimony you will give before the subcommittee will be the truth, the whole truth and nothing but the truth, so help you God?

Mr. MUNOZ. I do.

Mr. DUMONT. I do.

Chairman ROTH. And I would ask the interpreter to raise your right hand.

Do you swear and faithfully and accurately translate the testimony you shall hear?

Ms. KING. I do.

Chairman ROTH. Mr. Munoz, we would ask you to begin your testimony. We ask you to summarize and your full statement will be included in the record as if read.

TESTIMONY OF ANTONIO J. MUNOZ, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, BANCO FINANCIERO DE PUERTO RICO AS GIVEN THROUGH AN INTERPRETER, IRENE KING; AND JOSE DUMONT, CHIEF EXECUTIVE OFFICER, CARIBBEAN FEDERAL SAVINGS BANK

Mr. MUNOZ. Upon your request, I would like to speak in Spanish because it is very important for me to speak in Spanish, because of the importance of this event, and I believe my contribution can be much greater if I do so in my native language.

In my statement, I have stated, I have given the story of the banks. I have mentioned the size of the bank, the services which the bank provides to the members of the community, the policies and controls which we have in the bank, and we comply with the laws of the bank.

We have also included our revisions in the policy that took place after the events in Puerto Rico, and we have taken steps to train further all the people who work in our bank.

In order to comply with the cooperation which you are soliciting from me, I am available to answer any of the questions which you may have as far as my contribution can be in this respect.

Chairman ROTH. Mr. Dumont, will you please proceed?

Mr. DUMONT. Good morning, Mr. Chairman. I would like to request that I be allowed to read my written statement. It is only 6 pages. Perhaps it will be better.

Let me first provide you with some background information about the institution of which I became president and chief executive officer on June 18, 1985.

Caribbean Federal Savings Bank of Puerto Rico commenced operations in 1974 as a Federal mutual savings and loan association, and converted to a federally chartered mutual savings bank in 1984. Its main office is located in Carolina, a city in the eastern part of the San Juan metropolitan area. It has two branches, one located in Trujillo Alto, also on the east side of the San Juan metropolitan area, and one in Humacao, the city in the eastern part of the island. We will soon open our third branch in the middle of the San Juan metropolitan area, in Hato Rey.

During its 11 years of operations, Caribbean Federal has grown to some $66 million in assets as of May 31, 1985. Our assets consist primarily of first and second lien mortgage loans provided to over 1,400 homeowners. Our bank has funded its resources with savings deposits from customers and advances from the Federal Home Loan Bank of New York. As of May 31, 1985, its deposits consisted of $6.4 million in regular savings accounts; $800,000 in NOW accounts, $20.4 million in nonnegotiable savings certificates and $25.7 million in negotiable certificates of deposit. Advances as of that date amounted to $9 million. Net worth stood at $2.1 million, or 3.2 percent of assets.

When I was invited to attend these hearings, I was requested to address two subjects: what difficulties have arisen since the June 6, 1985 arrests of the three of these officers—president, vice president comptroller and Carolina branch manager; and how did I find things at Caribbean Federal when I became president a few weeks later.

When I arrived at Caribbean Federal, I found a group of 8 directors, headed by its chairman, and up to then, acting president and a group of 33 officers and employees who were working hard to keep the operations normal in the midst of adverse publicity, a downward trend in deposits and a managerial vacuum created by the abrupt loss of its top management.

Since I became president, management has addressed itself to establishing internal and accounting controls, a written operations procedures manual and a program for the continuing professional development of its personnel. Specifically, we have begun drafting a comprehensive compliance system; we have requested our outside auditors to perform a compliance audit and we have taken measures to restore public confidence in the bank, whose image had been damaged by the recent events.

As to compliance with the Currency and Foreign Transactions Reporting Act, it has been initially dealt with by the issuance of detailed written instructions to all branch personnel explaining its requirements and assigning specific responsibility for compliance to our branch managers who are, in turn, subject to management oversight.

In addition, personal meetings have been held with all branch managers to discuss the subject and clarify any remaining questions. We also had all branch managers and assistant branch managers attend a CFTR compliance seminar recently held under the sponsorship of the Puerto Rico League of Savings Institutions.

We would like to point out that thrift institutions generally have operational systems whereby, because of the formerly limited nature of their savings and mortgage loan operations, the teller still acts as the branch bookkeeper and performs the proof and transit tasks of the bank. Daily he or she credits the general ledger cash account for the amount of the beginning of day working fund and debits said cash account for the amount of the end of the day working fund. Under this system, the teller's proof, however, only shows the net amount of the day's cash movement, not the specific cash-in and cash-out transactions.

We at Caribbean Federal have now acquired the necessary computer software and are changing our present operational system to the one used by most commercial banks. Under the new system, the proof, transit, and bookkeeping functions will be moved from the tellers' windows to a separate department. This change will not only improve the service to our customers by reducing the window time of a transaction, but will provide an audit trail through separate cash-in and cash-out tickets for each cash transaction, thereby enabling the branch officers, the Federal examiners and the external auditors to better monitor the bank's compliance with the CFTR.

In addition to the above, the recent events required us immediately to address a liquidity problem created by unusually high withdrawals and the need to improve and expand the bank's operations in order to maximize profits and maintain our sound financial condition.

The liquidity problem has been solved with the support of the Federal Home Loan Bank of New York, which has expressed to us its intention to provide in the form of advances the funds necessary to meet possible withdrawals by depositors. We anticipate the repayment of any advances with funds to be generated from new savings instruments to be offered by Caribbean Federal in the near future.

While we are presently profitable and have maintained an adequate net worth, we are in the process of preparing a business plan to improve our financial results even further. We are confident that our goals will be met by improving our operations, providing adequate training to our personnel and expanding our services.

Since the recent unfortunate events, we have experienced a decrease of approximately 15 percent in our total deposits. This is understandable in view of the dramatic loss of the bank's top management, affecting the depositors' confidence in the institution notwithstanding its healthy financial condition. Part of my task is to assure the public of the bank's sound financial condition despite the allegations of misconduct on the part of the former officers.

Puerto Ricans, like American citizens everywhere, overwhelmingly are decent, law-abiding people who are united in their opposition to drug trafficking. Not only the banking sector, but all sectors of our community are fully committed to contribute in any way we can to the observance and enforcement of the laws and regulations that help to stop the traffic in drugs in Puerto Rico, the rest of the United States and the world. It is my personal conviction that if there is any corrupting influence of drug money on our financial institutions, it is only one part of the pervasive social and moral illness that drug trafficking represents, which must be attacked in a comprehensive manner.

In closing, I would like to thank the committee for the opportunity to express my views. I pray the Lord guides each of you in carrying on your work so that our generation and future generations of Americans may be freed from the deadly snare of illegal drugs. Mr. Chairman, I will answer any questions.

Chairman Roth. Mr. Munoz, we have heard that your bank has very detailed operating procedures and a strong internal audit system. Yet you are still faced with the arrest of two officers of your bank and with subsequent revelations discussed by Mr. Morley, could you please explain to us what happened and why your system did not work?

Mr. Munoz. Well, what really happened was these were separate acts by individuals who did not follow the bank's procedures and policies. Obviously, these were individual activities, individuals did not comply with the bank's policies to the full extent.

However, this was part of the specialized department which took in new deposits and new receipts. The person in charge of these activities had only been with us for approximately 3 weeks when he committed these actions, so there was really no time for us to put into effect our internal supervisory capacities.

Chairman Roth. In June 1983, you enacted internal controls over compliance to prevent recurring violations. Can you tell us what you did then and how what you are saying now differs?

Mr. Munoz. No, they do not differ. In fact, the things we did after June 6 was we called a board meeting with the executive members of the board to revise policies of the bank and also to implement and to put in training of our personnel and also to follow up on our supervisions and our policies. We have been doing this since the bank was established, and we have been improving these steps every year since then. In fact, all these inspections carried out by the FDIC have OK'd all the inspections they carried out; in fact, all the policies and situations we have carried out.

Chairman Roth. How is it possible your marketing director can sell hundreds of thousands of bearer certificates to individuals without your knowledge? Some of these individuals were among the biggest depositors in your bank; is that not true?

Mr. Munoz. Well, it is possible that some client that really didn't have much to do with the bank would come into the bank and have dealings with a special department, such as new accounts department. He had nothing to do with, say, public relations or the credit department. New accounts would be opened. These clients perhaps were associated with the bank for a period of 1 month, 60 days and I wouldn't know about them because they would not establish a fixed relationship with the bank. These people would become clients of the bank because of the attraction of the interest rates.

I don't really know what the full connection would be there, but the department which would attract these people would take care of these clients and basically it was a relationship in terms of CD's.

Chairman Roth. I would like to have your comments as to the reasons for the popularity of bearer certificates in Puerto Rico.

Mr. Munoz. The bearer certificates of deposit in Puerto Rico are attractive because of the negotiability of these instruments, primarily.

Chairman Roth. Many people think it is for purposes of evading taxes. Would you agree that that is a significant factor?

Mr. Munoz. No, I don't believe that is the main reason. Most of the depositors are properly identified. We have their social security numbers; we provide this information to the Department of Treasury. I don't see how they could avoid not paying taxes if we do give this information to the Department of Treasury. I would suspect the Department of Treasury would carry out their jobs as they are supposed to do.

Chairman ROTH. Does your bank file the appropriate reports with the Puerto Rican Treasury Department reporting each customer's interest received on bearer certificates?

Mr. MUNOZ. Yes, Mr. Chairman, our bank provides these reports to the Department of Treasury by account numbers, with social security numbers, according to the law.

Chairman ROTH. You would say those reports are full and complete year by year?

Mr. MUNOZ. Yes, there could, however, be change or some type of error which would only be considered an error, not something which was done intentionally in order to avoid taxes.

Chairman ROTH. Mr. Dumont——

Mr. DUMONT [interposing]. Yes, Mr. Chairman?

Chairman ROTH. Have you personally read the currency reporting and recordkeeping regulations contained in title 31, specifically part 103 of title 31?

Mr. DUMONT. I have not had the opportunity to read the entire regulation, but through several compliance officers, I have become quite familiar with it.

Chairman ROTH. If I came into your institution today with $100,000 in cash to buy a bearer certificate of deposit would you please tell me what you would do. Who would I deal with at the bank, what records would be kept and where?

Mr. DUMONT. Mr. Chairman, the first thing to do is determine whether you are a regular customer or not. Let's assume you are not. We would try to, we will identify the customer to have positive identification from him, obtain name, address, social security number and I.D. We would then try to determine the source of the funds. If we find they come from illegal sources, we would see an agent. A copy of the CD will be kept by the institution to be filed. The corresponding form 4789 would be filed with the IRS and your name, address, social security I.D. number would be entered into our log which includes the CD number, amount, all this information, name, address, social security I.D. of the purchaser, the dates of maturity. What I do is actually pay on the dates that interest is due.

As to the cash—maybe I should expand. As to the cash portion under the present system, the teller would have to record that cash amount in cash transactions in excess of $10,000. The branch officer will decide whether a form 4789 has to be filed. If it is not within the exempt list of our customers, at the present time in Caribbean Federal, that would go for all transactions since we have no exempt list of customers.

I understand that the Federal agents that searched the premises of Caribbean on June 6 took whatever record there was, if any. Since then, we have given no exception to anyone. Right now, there is no exception in Caribbean.

Chairman ROTH. Obviously, there are some legitimate reasons for bearer certificates of deposit. Are they used primarily as a means to evade Puerto Rican taxes, or is that a principal reason for them?

Mr. DUMONT. That I don't know, Mr. Chairman. CD's, like my colleague said, are negotiable instruments which require no endorsement. They are pledged as collateral.

I don't know why people would think about using a CD for evading taxes.

Chairman ROTH. We have heard testimony that Caribbean pays much of its bearer certificate interest in cash and did not report these payments to Treasury. Do you still pay this interest in cash?

Mr. DUMONT. Excuse me?

Chairman ROTH. Do you still pay this interest in cash?

Mr. DUMONT. Yes, we do.

Chairman ROTH. You still do?

Mr. DUMONT. Yes, sir, we do.

Chairman ROTH. How do you plan to deal with the interest reporting delinquencies? Is this something you can do after the fact or is that information lost?

Mr. DUMONT. No; when we pay the interest, we take the information from where the interest is paid. Should it be determined, it is not very clear to us right now, that we have to give that information to Treasury—if it be determined that we do have to do it—we will have the information available. All types of financial institutions must submit to Treasury to whom interest was paid on all types of savings instruments, including certificates of deposit.

Chairman ROTH. Mr. Rinzel?

Mr. RINZEL. Thank you, Mr. Chairman. I would like to direct a question both to Mr. Munoz and Mr. Dumont. Each of you have said that you think liquidity is the primary reason why people are interested in purchasing bearer CD's, but isn't it true that very few of these bearer CD's are cashed in prior to maturity and doesn't that indicate that liquidity isn't the main interest?

Mr. DUMONT. Negotiable certificates of deposit when issued are not subject to cancellation prior to maturity. The only way you could know where it was would be comparing the names of whoever it was issued against seeing who collected at the time.

Mr. RINZEL. I didn't mean to say turn in; I meant to say sold. The person who cashes in the certificate is the same person who purchased it, isn't it, in the vast majority of cases?

Mr. DUMONT. I don't have the answer to that question, Mr. Rinzel.

Mr. RINZEL. Mr. Munoz?

Mr. MUNOZ. CD's are negotiable, but some of them are negotiable before their maturity date. Usually the person who gets the interest is the person who negotiated.

Mr. RINZEL. I recently saw an article in the San Juan Star which quoted the Governor of Puerto Rico as saying that everybody in Puerto Rico knows that these bearer certificates have been used to evade taxes and that the tax rate is too high and that is why people use it.

Are each of you saying something different now? Do you disagree with what the Governor says?

Mr. DUMONT. Sir, on my part, I am not disagreeing with the Governor. What I am saying is I don't have any evidence to compare with his or disagree whether such is the case.

Mr. RINZEL. Mr. Munoz?

Mr. MUNOZ. I personally know as far as commercial banks are concerned, I'm not talking about savings banks but commercial banks are regulated by the Department of Treasury. There are 16 commercial banks in Puerto Rico and each one of them offers information to the Department of Treasury as far as tax payments are concerned.

So, in other words, commercial banks really can't avoid tax payment because the information is given to the Department of Treasury under those regulations.

Mr. RINZEL. We heard testimony from Mr. Morley about the lack of accurate records in various institutions that he looked at in Puerto Rico regarding the purchasers of bearer CD's. Isn't that a direct invitation to money launderers when they realize that such a system exists and is easily used? Isn't that a direct invitation to money launderers to use the bearer CD route to launder their drug money?

Mr. MUNOZ. Well, I don't think there—I don't think they use bearer certificates of deposit in this manner because these transactions are registered and most of them are carried by checks. It is easy to identify transaction order, be it by check or by cash. If it is a cash transaction, form 919 has to be filled out and submitted and if it is by check, then the check is very easy to trace. Because of the rules that govern bearer certificates of deposit, I really can't see how these instruments will be easy to use as instruments in laundering money.

Mr. RINZEL. Simply by using phony names and addresses and social security numbers and identifying the purchasers as "bug-eyed" or "one arm" or "red haired" instead with their true names and addresses and social security number.

Mr. MUNOZ. Well, I still believe that it's hard but I'm not saying it cannot happen. Policies and instructions and the supervisory procedures of our bank demand all of these things. Regulations are adhered to and everything has to be correct if it is submitted to us, this information has to be correct.

In our bank, we usually know the clients that we deal with, and we believe we can identify any type of illegal operations. We know the client.

Mr. RINZEL. Mr. Chairman, I don't have any further questions. Thank you.

Chairman ROTH. Gentlemen, that is all the questions. I will say that I am disappointed with the lack of candor. I think until there is a better understanding in recognition of the problem, it is going to be very difficult to correct. I can assure you that we are deeply concerned because we think that the evidence shows that in some institutions, the controls are inadequate, and I feel very, very strongly that money laundering operations are what make illicit drug operations possible. We are not going to be satisfied until all financial institutions, including your own, comply strictly with the law.

Thank you, gentlemen. That is all.

Mr. DUMONT. Thank you, Mr. Chairman.

[Mr. Munoz's prepared statement follows:]

Prepared Statement of Antonio Muñoz

Chairman of the Board and Chief Executive Officer of Banco Financiero de Puerto Rico

Pursuant to your invitation to appear in writing before the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs of the Senate of the United States of America, presided by the Honorable Senator William V. Roth, Jr., and in order to provide said subcommittee with information regarding Banco Financiero de Puerto Rico's (hereinafter the "Bank") internal procedure for financial record keeping of currency transactions, as required by the Bank Secrecy Act, we hereby inform you as follows:

Before going into the subject of this statement we consider it appropriate to present some background information about the Bank.

The Bank was organized in the City of Ponce, Puerto Rico as a savings and loan bank in the year 1975. From its establishment the Bank faced difficulties growing as a savings bank on account of constantly fluctuating and volatile interest rates, an economic condition that affected savings and loan institutions all over the United States. Further hardship was brought upon by the fact that in accordance with its charter the Bank was limited primarily to granting long-term mortgage loans, a type of investment which became a scarce commodity during those years.

Consequently, in 1980 the Stockholders and the Board of Directors of the Bank approved a resolution to convert the Bank into a commercial one. After a thorough investigation of the Bank, approval of such a conversion was obtained from the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Bank of New York and the Department of the Treasury of the Commonwealth of Puerto Rico and the change into a commercial bank became effective on November 27, 1981.

Until then the Bank conducted all of its business from its main office in the City of Ponce and as of December 31st., 1980 its stockholder's equity amounted to $1,460,909. At the same time that the conversion was approved, the previously cited regulatory authorities, which retained supervisory responsibility over the Bank, authorized the opening of two branch offices, one to be located in the Hato Rey financial district, and the other in the City of Ponce, where the main office is located.

As part of this expansion the Bank had to increase its paid-in capital requirements by $1,600,000. The investment was made and both new branches were in operation by the middle of the year 1982.

The Bank is small, even though as of December 31, 1984 the Bank had a stockholder's equity of $8,897,968. In anticipation of further growth and because of the need to assure the efficient operation of its activities back in 1980, it recruited new executives and employees. Part of this group includes Mr. Samuel Zayas, who became and since then has served as Vice-President in charge of operations and Mr. Pedro J. Suau, as Vice-President in charge of the San Juan area, presently in charge of the administration of credit. Both executives provided the Bank with the management knowledge and expertise that the recent expansion demanded.

Needless to say, the size of a bank is an important element in almost any consideration. It certainly is in terms of growth potential and ability to compete, and it can be affirmed that the Banking Industry is a highly competitive one and size in itself can give some of its members a clear competitive advantage.

Be that as it may, the ability to understand and rigorously apply the requirements of the law in most instances should not be related to the size of an institution. At Banco Financiero de Puerto Rico, and concerning the matter at hand, that is the application of the Bank Secrecy Act, we do not see size as a relevant issue, since we are convinced that as an institution, we have observed the correct procedures in the past, and will continue to do so in the future.

However, before going any further we must express our concern regarding the manner in which the law enforcement authorities executed the raid of commercial banks on June 6 of this year in Puerto Rico. The harm done to Puerto Rico's financial image and to small banks such as ours is not commensurate with the acts attributed to individuals within the banking industry in Puerto Rico. While we are convinced and have been convinced of the need to comply with the Bank Secrecy Act as a tool for the prosecution of major crimes, we must point out that in the case of commercial banks which are members of the Puerto Rico Bankers Association and insured by the FDIC, and supervised by the Treasury Department of the Commonwealth of Puerto Rico, it would have been most helpful to ascertain first, whether banks under their jurisdiction had been in compliance before the raid and the disproportionally damaging publicity that accompanied the raid took place.

In reading about the apparent lack of communication and coordination that appears to exist between the regulatory and the law enforcement authorities, one cannot avoid concluding that the initial effort should have been to correct this lack of communication and coordination. Then and only after it could be concluded that banks in general in Puerto Rico or any other place within the jurisdiction of the law enforcement authorities, as institutions, had been deliberately indifferent to the legal mandate of complying with the Act, then and in such an event a raid as the one blatantly effected in Puerto Rico can be justified.

Such is not the case, either with regards to our Bank or the banking industry in Puerto Rico. We, as an industry are fully aware and diligently complying with the Act and we hope that at the conclusion of these hearings, the Sub-committee and -------

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eventually the Senate of the United States of America will be convinced of this.

The Bank, as previously stated, in 1981 changed from a savings bank to a commercial bank, and at the same time grew from one main office in the City Ponce and a branch in the town of Juana Díaz, to an additional branch in the City of Ponce, another in Hato Rey, which is the business and financial district of San Juan, Capital of Puerto Rico, and most recently one in the town of Guánica, which it acquired from the Royal Bank of Canada.

From the beginning of its operations as a commercial bank, the Bank adopted a compliance manual, a copy of which is attached herewith, as part of this statement.

Please note that one of the purposes of said manual is to assist the Bank's staff in complying with "statutory and regulatory overview and operational procedures".

To effect the above purpose, the Bank has placed a Senior Vice President in charge of its operation division, which has the responsibility to train and supervise the managers and operation officers of each branch. As often as every three months seminars are held to assure the efficient application of the "compliance manual" and acquaint the personnel of the Bank with changes in rules and procedures, if any.

Said Senior Vice President responds directly to the President and Chief Executive Officer of the Bank, who in turn responds directly to the Board of Directors in all compliance matters.

The manual provides that all senior officers, a group which now consists of three Senior Vice Presidents and the President and Chief Executive Officer, are included and form a part of the Bank's compliance task force.

In addition to the compliance task force and the individual compliance officers, the Bank has an internal audit division, which consists of three auditors which work under the direction of a CPA who is not an employee of the Bank, but is a member of the Board of Directors. Yearly, the Bank is audited by an external CPA firm, the Commonwealth's Treasury Department and the FDIC. In this respect it must be noted that the FDIC is the only regulatory agency which conducts separate compliance examinations.[1/]

As can be readily noted, the manual is complete regarding compliance with the applicable federal laws and specifically with regards to financial record keeping ("currency transactions"). In accordance therewith the personnel customarily involved in these transactions to wit: the teller and the branch operation officer have been specifically instructed to proceed as follows:

1. The teller is required to identify the currency transaction or multiple transactions of more than $10,000 in any one

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[1/] The FDIC, during its yearly audit has found that the Bank is in compliance with the Bank Secrecy Act both in regards to filing the CTR's and adhering to the Treasury Department regulations for exempt customers.

day as provided in the compliance manual, unless such "person" effecting the transaction is an exempt customer of the Bank. Each teller has immediate access to a list of the exempt customers of the Bank.

2. Once the non exempt transaction has been identified, the teller will refer the matter to the branch's operation officer, who will then have the responsibility to prepare and file the Currency Transaction Report, (hereinafter referred to as the CTR).

3. The operations officer will then mail the original of the report to the IRS. A copy is retained at the branch and a second copy is sent to the main office which serves as central clearing house for the Bank. Both copies must bear the teller's identification stamp. This latter step, gives the teller the additional responsibility of knowing if the currency transaction report has been duly completed.

4. With respect to the filing of the "Report of International Transportation of Currency or Monetary Instruments", the procedure established by the Bank requires that all transfers be made through the main office, where the Telex system is located. The report is prepared by the operations officer of the branch following the same procedures established for CTR's explained above. However, in view of the size of the Bank and the fact that its business is almost exclusively conducted with respect to

local transactions, the number of international currency transactions is extremely limited.

In the case of a sale of a manager's check the compliance manual (page II-9-8) provides that all manager's checks must be approved by an officer and shall contain two signatures, one of which must be that of an officer of the Bank. The procedure established by the Bank requires that a teller receive the application for the check and the funds, then prepare the manager's check, which is never issued to bearer or in blank, and deliver it to an officer for approval and signature.

It is the teller's duty to follow in this case, the same procedure explained above for deposits.

As a result of the recent events (June 6th., 1985) which resulted in the indictment of employees of various banks in the Commonwealth of Puerto Rico for failure to file the CTR's in cases involving transactions that exceeded $10,000, the Bank has taken the following measures to further strengthen its operation procedure:

1. All the pertinent personnel was convened at a meeting held on June 10, 1985 at the main office to review the procedures, examine the causes for the failure, and suggest new courses of action.

2. The Senior Vice President for Operations and the Senior Vice President for Credit Administration of the Bank shortly thereafter, attended a meeting of all senior executives of

commercial banks called by The Puerto Rico Bankers Association to discuss and review the currency procedures, etc.

As a result of the above it has been concluded:

(A) That the personnel of the Bank has been duly informed and were duly informed of the need to file the currency transaction report, wherever applicable.

(B) That in spite of the above, some individuals have presumably violated this procedure.

(C) That an awareness has developed, calling for more scrutiny between and among all the personnel involved in these transactions. They have been asked to and are apt to be more watchful of the legal need to comply with the procedure. This is expected to bring about more control, for example:

1. Tellers, in addition to previously fixing their identification stamp on the second copy of the currency report, have established a follow-up procedure, wherein they will assure themselves that the currency report has been filed in those cases identified by them to be non exempt.

2. Personnel required to countersign manager's checks have been asked to be more watchful of these transactions and to rely on their own knowledge of the transactions, as opposed to total reliance in the person initiating and approving the preparation of the manager's check.

3. The list of exempt transactions, which is reviewed every six months, has been carefully examined and found to be correct.

4. The Bank had begun, over a year ago, a public relations campaign promoting better relations with its customers. This is expected, among other things, to better acquaint the Bank's personnel with its clients and prevent obscure or anonymous persons from using the Bank for unlawful or devious purposes. In this respect it must be noted, that of the five branches only one is located in a city with large population movements and is therefore liable of being more exposed to the problem.

I would like to finish my remarks by restating our full support to the efforts of this Committee in the prevention of the use by criminals of established financial institutions for the benefit of their ilegal activities. I also share Chairman Roth's concern that drug abuse is one of the most serious problems facing this country and that banks have a responsibility to assist in the battle of law enforcement.

Respectfully submitted this 22nd day of July, 1985,

Antonio J. Muñoz

Chairman **Roth**. At this time, I would like to call forward Mr. Ledesma and Mr. Mier, please. Please raise your right hand.

Do you swear the testimony you will give before this subcommittee will be the truth, the whole truth and nothing but the truth, so help you God?

Mr. **Ledesma**. I do.

Mr. **Mier**. I do.

Chairman **Roth**. Gentlemen, we appreciate you being here. Your full statements will be included in the record as if read. I would appreciate if you could summarize it. Mr. Ledesma?

TESTIMONY OF HECTOR LEDESMA, PRESIDENT, PUERTO RICO BANKERS ASSOCIATION AND CHIEF EXECUTIVE OFFICER, BANCO POPULAR DE PUERTO RICO, AND MARIANO J. MIER, PRESIDENT, PUERTO RICO SAVINGS & LOAN ASSOCIATION AND PRESIDENT, FIRST FEDERAL SAVINGS BANK

Mr. **Ledesma**. Thank you, Mr. Chairman. For the record, my name is Hector Ledesma. I am president of the Puerto Bankers Association. I am also president of Banco Popular de Puerto Rico.

We really appreciate the opportunity to come before you on this very important issue. I would like to give you a very short overview of banking in Puerto Rico, the composition of the banking industry and in my testimony, I will be referring mostly to the commercial bank end of the business.

We have some of the most important banks in the world, some of the leading banks in the United States, in Canada, in Spain, as well as substantial local banks that have evolved as the economy of Puerto Rico has evolved from the local side.

One of the areas that I would like to clarify in the statements made previously by Mr. Blau, he quoted some data relative to bank deposits which apparently contains a typographical error because the information that I have here, which is published by the Government Development Bank for Puerto Rico shows the banking deposit growth in Puerto Rico, and just to give you a ballpark figure, in 1980, the deposits in the commercial banks were $8.6 billion; in 1982, $10.9 billion; in 1983, $12 billion and in 1984, and I am quoting as of December 31, about $13 billion.

So as you can see, there has been a steady growth.

At this time, I would also like to offer as additional evidence the statement that I read at the Ways and Means hearings held on July 11, 1985, which will give you a great deal of information about the composition of these deposits.

Very briefly, I have to clarify this area because when you look at figures sometimes it is good to analyze the facts behind the figures. In 1976, the Internal Revenue Code, section 931 that dealt with the exemption of profits generated by U.S. companies and possessions was changed. Before that time, most deposits were outside the banking system in Puerto Rico or the banking system in the United States, for that matter. They were mostly in the Eurodollar market. When the law was changed in 1976, many of the earnings of these companies were brought back to Puerto Rico so the increases that you see in the deposits in the banking sector account for the return of those profits.

Just to give you another figure that is easy to remember, as of right now, from 40 to 44 percent of banking deposits in Puerto Rico belong to these 936 companies. So that shows you clearly these are substantial amounts which have increased the deposits in the banking system.

This may clarify this matter, and I would like to submit also the economic indicators published by the Government Development Bank that can give the committee additional information.

Going back to the testimony, we operate through substantially a branch system. There are over 300 branches in Puerto Rico. Most of the branches are in some of the large metropolitan areas, but we also have branches throughout the Island. In the case of the commercial banks, we also have trust companies that do not have a significant number of branches and they are really part of our association, but the bulk of the deposits are in the U.S. banks, in the Canadian banks and in the Puerto Rican banks.

The banks doing business in Puerto Rico have a tradition and not only a tradition, it is a policy to comply not only with Federal but with local banking regulations. We are examined by a handful of Federal organizations.

In the case of the commercial banks, we are supervised by the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve Bank. We are also supervised closely by the Secretary of the Treasury of the Commonwealth of Puerto Rico. We also have, and especially most of the large banks have, outside auditing firms, such as the ones that were mentioned here previously, that also go over our figures and certify the correctness of our financial statement.

I would like to devote a little time to the efforts that we have made in the banking system to comply with all compliance laws and there are a multitude of Federal laws that require compliance, but specifically the Bank Secrecy Act. The banking industry has made every effort to comply with this regulation. As a matter of fact, before the Secrecy Act was enacted, since 1950, our own Puerto Rican laws require a great deal of disclosure that is now being required by the Bank Secrecy Act, especially, Mr. Chairman, you were referring to the payment of interest on deposits.

Our laws are very specific in connection with the obligation of banks to report to the local Treasury Department payment of interest, over $100 per customer. This information is then forwarded to the Treasury Department on a yearly basis.

Also, the retention of records is very important. Our local law goes much further. We have to retain most records from 10 to 15 years. The title 2, which we are addressing today, has received a great deal of attention and, as a matter of fact, we have been holding seminars, very frequently, on all the implications of complying with this very difficult regulation because it is lengthy. Of course, when you summarize the very important points, I think that it is much easier to give that information to your personnel rather than just give them a copy of the law.

In our bank, we have summarized the law, and we issue bulletins that informs them changes that are being made, requirements that are being added or deleted and internal policies of our bank concerning the reporting of all these transactions.

In the Puerto Rico Bankers Association, we have also adhered to compliance regulations. As a matter of fact, one of the first meetings that the Operation Greenback staff held in Puerto Rico in 1982 was with our bankers association.

On December 1, 1982, we had a meeting and they told us what the problems were and they gave us an idea as to the action that they would be taking in the future. So communication at that time was very good. Most banks followed with meetings with their own staffs.

For example, in our bank, we met on a local holiday, on the 11th of January 1983, we pulled back key personnel from the branches and we have 112 branches. We had the managers, the assistant managers and others to discuss the law. We had people from Treasury, from Customs, from the FBI giving us very clear information as to what they were looking for.

So from that point on, we emphasized the compliance in the area of Bank Secrecy, but really we had this mechanism in place at all times.

I have here with me our compliance officer, Ms. Margarita Herrera. We have given our staff a very thorough training. As you know, the American Bankers Association offers a compliance school for bankers and I would suggest, Mr. Chairman, that one of the areas that you should really pursue is also dealing with trade organizations, such as the American Bankers, because I know, I participate in many of their meetings, and they are trying to do a job, but my feeling is that you have to go to the top at each bank. Compliance starts at the top. It cannot start at the teller's level because this is a burdensome process; this requires a great deal of paperwork and unless a CEO or president of the bank makes it very clear that we will not do any business unless we comply with each law, whatever happens from that point is going to be very difficult to administer.

Personally, from the very first time that we started to deal with compliance, I personally attended all the seminars. I went out, I saw people and then we hired competent people in the bank. Today we have 12 persons in our compliance area. This is outside of our general internal auditing staff that also goes through all the documents that have to be filed. So the internal auditing procedure must be coupled together with the compliance effort because to me this is your best source of information to detect whether or not you are in compliance.

I would like to submit for the record the compliance training program that we have at the bank. Again, I have to give a great deal of credit to Ms. Herrera who is here. She approached this from a practical viewpoint. She is a lawyer; she read the law. After reading the law, she prepared a set of guidelines. As a matter of fact, she also prepared samples of each of the documents that had to be filed offering 15 or 20 alternatives that could come up so that our personnel in the front line if in doubt, could also refer to some of these forms that were properly filled out. I can write memorandums and do other things. However, I also have to be sure that compliance is effective.

She goes out and whenever our auditing department examines a branch, she will get back whatever comments they have regarding compliance, and she will see that whatever deviations, if any, and I can tell you that we are human, we may find one or two things that are not done, are corrected right away.

So to me, the success of compliance starts at the top with awareness from your board of directors, your senior officers, your people in the front line, and the tellers because the tellers are the main linkage with our depositors and although they really have to be friendly with the depositors, they also have to be firm in asking the proper information.

We also went as far as having quizzes, tests, because you can be imparting a great deal of information and you don't know if the information is being analyzed and is being understood. Ms. Herrera devised many, many of the simple tests to challenge people, to see if they really understood the regulation. Maybe this is why in our particular case we have been examined by the FDIC in the last 5 years and they have found very few deviations, if any.

This is one area, by the way, which I think I would like to give credit to FDIC. FDIC separated their yearly compliance inspections from those in the area of credit policy, management of funds, and so forth. So the compliance examiner comes at a different time than the other general examination that is conducted throughout the bank.

To me this has been very effective because you have a very small group of very knowledgeable people that can come and pinpoint the areas that you need to examine very thoroughly. So maybe separating the two examinations is a procedure that should be considered because compliance is not a subject that is easy to police.

We also went as far as issuing a monthly compliance bulletin, and I have reports that I would like to submit where we go through specific transactions. We also analyze the paperwork we are receiving to see if it has been properly filed. But we went one step further. When these forms 4789 are filled out at the branch, they could be remitted directly to the federal agency in the United States. In our bank, we centralize the forms, the 4789. They come to our compliance officer. Our compliance officer will go though them and forward them directly to the Federal agency. I would like to clarify for the record that in our bank, we are filing an average of 250 to 300 forms weekly, contrary to some of the low figures that I have heard today in other testimonies in the past.

So the volume of business—and this is outside of the exemptions which, by the way, we review the list twice a year or as frequently as needed. So from the point of view of direct contact, in our bank and I would say in a general statement, in other commercial banks in Puerto Rico, compliance has been not a part-time job but a full-time job.

I would like just to make a closing statement, Mr. Chairman, because I think we are going further than just a banking industry. Whenever banks do something wrong, whenever some information comes up it gets the front lines, not only of the newspapers, which by the way have treated this matter in a very professional way, but also by television and other media that not only stays within Puerto Rico but goes much further outside of Puerto Rico.

I believe that the actions that were taken in the past several months have not only damaged the reputation of the banking system that has served Puerto Rico very well, but has also tainted the overall image that Puerto Rico may have in the mainland.

Right now we are dealing with Congress in many vital areas—such as section 936 that greatly influences industrial development in Puerto Rico and the role we are going to play in the development of the Caribbean area—that could be tarnished, if I could use that word. I know this is not your intention because I can see that you are calling us not merely to get information from us, but to establish a much better communication between the regulators, the legislators and the business people.

I urge you, Mr. Chairman, and I place the resources of the entire banking community in Puerto Rico at your disposal to speed up this investigation. The statements that I heard this morning, particularly from Mr. Charles Blau, are too general. I would like to see if there are some specific violations. I realize investigations are taking place and maybe there is information that has not been given, but there are a series of statements here that if read out of context or even if read within the context could be very misleading.

On the other hand, I have to give credit to your staff, and I am not just trying to be nice. Mr. Morley arrived in Puerto Rico and within 2 weeks, he had done more work in going to the substance of this problem than maybe other people that have devoted more time. I have clarified the bank deposits. I would like now to touch very briefly on the cash depots.

Cash depots are a function of the Federal Reserve System. A daily statement is sent to the Federal Reserve of New York which handles the local depot through a bank in Puerto Rico, Banco de Ponce. These increases mentioned by Mr. Blau have not gone up in just 1 or 2 years, but have gone up gradually, are operations that banks in Puerto Rico are conducting.

Again, I urge you if there are any doubts in that area, inasmuch as we are talking about fairly large amounts, that you ask specifically to the banks, because we have done that already and they can attest to the flow of money that is coming into Puerto Rico, mostly from branch operations of large branches or affiliated banks in the Caribbean area.

So, again, 300 million figure that was mentioned as increase in the cash depot figures, again, could throw a red flag and people could say: "Gee, that is a lot of drug money that is coming in there." I think it's our responsibility as responsible people to give you the information that you need. Please ask us for more information if so needed. We will be very happy to give it to you. Thank you very much, Mr. Chairman.

Chairman ROTH. Thank you. I want to say publicly here the two gentlemen who have been before me have been leaders in trying to correct the situation and make sure that there is compliance. I want that to be known. One of the problems when you investigate a serious problem is that those that do wrong make the headlines and those that do well are forgotten. But I think it is important that it be understood and I would hope that the press would report it, that much of the banking industry in Puerto Rico is complying and trying to live within the law. That is important. I think the leadership you two gentlemen are showing is extraordinarily important. I think maybe we should have you take over the Federal

Home Loan Bank Board [laughter] at least insofar as training them and enforcement of the law.

And, Mr. Mier, I want to thank you, too, and invite you now to proceed with whatever remarks you care to make.

Mr. MIER. Thank you, Mr. Chairman. My name is Mariano Mier. I am president and chief executive officer of First Federal Savings Bank of Puerto Rico. In addition, I am president of the Puerto Rico League of Savings Institutions, and it is in this capacity that I appear before you today.

The savings and loan industry on the island consists of 12 institutions, operating under the provisions of the Homeowner's Loan Act of 1933. They have combined assets totalling $4.5 billion, of which 48.8 percent or $2.2 billion are concentrated in two institutions—First Federal Savings Bank and Caguas Federal Savings Bank.

We are regulated and supervised by the same regulators and supervisors—in our case the Federal Home Loan Bank and the Federal Savings and Loan Insurance Corporation—as are our fellow thrifters in Florida, Georgia, Delaware, or Alaska.

Therefore, we are prone to face the same challenges that the financial community faces throughout the United States.

We, thus, benefit from the same benefits that the mainland financial community enjoys and are affected by the same problems they endure.

Nonetheless, the events of last June 6, have significantly altered the image of an industry that until that date had not been suspect of wrongdoing, least of all of collaboration with organized crime.

On that unmemorable date, Federal law enforcement agents arrested in Puerto Rico 14 financial institution employees, including a bank president, on charges of conspiring to illegally launder money, most of which allegedly is derived from drug-related activities.

The disclosure of these actions, undertaken by an army of more than 200 agents, took everyone by surprise and have shamed the honest, law-abiding Puerto Rican business community.

Even though I was aware of the undercover investigation that was underway and had been, as head of the island's oldest and largest thrift institution, in close collaboration with regulators and law enforcement officials, the first I heard of the June 6 raid was from the late Bryce Curry, president of the Federal Home Loan Bank of New York, who called my office minutes after our largest branch was intervened by Federal agents.

My initial reaction was one of shock at the magnitude of the operation which included, not only savings and loan institutions but also commercial banks.

I was also surprised that agents had raided our largest branch for I, personally, have been the most persistent and obsessive watchdog of compliance with all the laws and regulations which apply to our industry.

My initial surprise at the unexpected raid of our Plaza Las Americas branch changed drastically during the rest of the afternoon as more information became available regarding the scope of the actions.

First of all, the only reason Federal agents had entered our premises was to secure documents dealing with transactions that had been carried out in one account by a former employee of our institution, who was asked to resign more than a year prior to the events of June 6 as a result of his failure to adhere to our compliance and internal audit procedures.

In the spring of 1984, he was placed on probation due to some operational deficiencies discovered in the course of an internal audit.

Subsequent to that action, the employee called our compliance office to give his reasons for the late submittal of a currency transaction form. At the same time, the employee communicated to our senior vice president in charge of operations to inform him about a currency transaction that he claimed, and I quote, "was suspicious."

Our operations director proceeded to meet with special agent Rafael Rivera of the U.S. Customs Service who informed our officer that the employee's assertions were false, that he was under surveillance and would be arrested.

Under the circumstances, in order not to compromise the Federal investigation underway, we asked for the employee's immediate resignation based on his prior operational deficiencies.

Almost a year later he was arrested by Federal agents and charged with violating the Bank Secrecy Act.

On June 6, as my concerns for the prestige and well-being of my own institution subsided, preoccupation for the effects of the day's actions not only on our thrift industry, but on our entire financial community, as well as on Puerto Rico, began to mount.

I felt no satisfaction from the knowledge that my institution, First Federal Savings Bank, had survived the ordeal untarnished. I, after all, had been entrusted, just 2 months before, with the presidency of the Puerto Rico League of Savings Institutions, and had far greater responsibilities than those of my institution. I now was custodian of the trust, the welfare and well-being not just for First Federal Savings Bank, but for the entire industry.

The scandal, which was prominently displayed by both the local and national media, was unprecedented in Puerto Rico's history. Until that day, the only precedents we had were those of similar violations found in a host of financial institutions in the mainland United States.

In my new position as president of the Puerto Rico League of Savings Institutions, a post almost as new as my initiation as a thrifter, for prior to December 1982 I had been a commercial banker for almost all my professional life, it was of paramount importance to leave aside competitive considerations and address the problem from the vantage point of how to stop whatever erosion in the people's confidence in our industry had resulted from the arrests.

On June 13, after chairing a board meeting of our league, in a prepared statement released to the local media, I reaffirmed, as I had done following the arrests of June 6, our full cooperation with the continuing Federal investigation and welcomed the opportunity to get rid of any unscrupulous member of our financial community found in violation of the law and/or the regulations.

At the same time, I offered my fellow thrifters the services of our own compliance officer at First Federal Savings Bank, who personally headed an in-depth compliance seminar for all member institutions last June 22.

As I cannot be fully conversant about the compliance procedures that have been followed or that are now being followed by all the thrift institutions on the island and since my participation in this industry is of recent vintage, I beg that you allow me to share with you the experiences that I have had at First Federal.

It was obvious from the beginning that the institution, with total assets of $1.2 billion and 22 branch offices, was in dire need of a complete overhaul, not only of its systems, but also of its administrative culture. Changes were made. New faces brought in. Systems were updated. As a result, the bank has turned around dramatically, showing net profits for the last 30 months and is well on its way to recovery. Yet, the overhaul we began in 1983 continues.

One area to which I personally devoted special attention, for it is an area that I feel should be addressed to by the chief executive officer, was the matter of compliance with all the laws and regulations.

A compliance officer with extensive commercial compliance banking experience was hired. A compliance office was created and has subsequently been revamped and expanded. All compliance procedures, manuals and trainings were examined and restructured.

Our records show that the institution's compliance guidelines for currency transactions promulgated in 1972 had been first revised, 10 years later, in 1982.

We reviewed the guidelines and issued a revised operations manual in August 1983. This new set of guidelines was subsequently expanded and is constantly under review.

The Secretary of the Treasury requires that any and all deposits, withdrawals, exchanges of currency, or other payments or transfers which involves a transaction in currency of more than $10,000 be reported to the Internal Revenue Service by filing form 4789 within 15 days of the transaction.

At First Federal, we file our form 4789 reports each week.

In addition, all branch transactions requiring the filing of form 4789 must be submitted to our central compliance office within 3 days of the date of the transaction for auditing and review, so as to double check close adherence with the intent and spirit of the law.

The Federal regulations, nonetheless, establish an exemption to this rule in cases that basically involve retail establishments which handle large sums of currency. While some of our clients fall under this classification, their exempt status petition filed by our branch managers is revised by our central compliance office and, if found unjustified, is immediately overruled and forced to conform to the standard currency reporting obligations.

In addition, branchwide exempt lists are revised by our compliance officer every semester.

In March of this year, we also started a branch-by-branch record of any and all telephone conversations or consultations made with our central compliance office regarding the filing of form 4789.

As an additional control, the audit division has been entrusted with the branch-by-branch audit of form 4789, which is conducted during the review of teller transactions.

The audit division is charged, also, with the responsibility of constantly examining the working funds of each branch operation in order to determine, at any given time, whether an unusual amount of cash is requested or reported by each audited unit.

Violations of these operational guidelines are not only frowned upon but acted upon immediately as can be confirmed by our personnel records.

Another important aspect of our compliance efforts involves the continuous training of our personnel, from senior executives to branch managers to tellers. Since April 1984, we have held six different compliance seminars for our bank's employees. In addition, new recruits have to go through a cash transaction compliance seminar that is not elective but compulsory for all employees regardless of position or experience.

Another problem we are in the process of correcting is the absence of adequate software in the bank's electronic data system that will enable us to track down and profile cash transactions. All deposits and withdrawals, without exception, appear as cash transactions whether or not they are cash based.

In order to correct this situation and allow us to have a better centralized control of transactions, a new mainframe computer and software have been purchased to replace our old thrift operations software. This new system, which will be partially operational by the end of this year and fully operational by 1986, will provide a true portrayal of transactions and augment our enforcement and compliance capabilities.

No system is perfect or infallible. That is why we all have the responsibility to be vigilant at all times and, least of all, to fall into complacency or neglect.

Less than 2 weeks ago, on July 12, I was elected to my first full term as president of the Puerto Rico League of Savings Institutions and in my acceptance speech stressed the need for stronger compliance with the laws and regulations of our industry.

I would like to quote to you briefly from those remarks:

"Bryce Curry was a true friend of Puerto Rico and the Puerto Ricans. Because of him, we can proclaim the rehabilitation of an industry that without his help would have gone under. We will definitely miss Bryce.

Yet, we cannot miss those who violated our trust and confidence and embarked on personal adventures foreign to the best interests of our industry.

That is right now our biggest task: To look inward, not in an unproductive and narcissistic fashion, but with a sense of commitment towards the utmost care in strengthening our compliance and respect for the industry's standards and regulations.

There cannot be any deviation from the norm. This task, contrary to what some might profess, is not a task for regulators, it is a task for all of us in this room.

I am personally committed, as I have always been, to the upholding of the law and the regulations of our industry.

This is not a time for laxity. This is not a time for "Ay bendito." This is a time for all the honest and hard-working men and women in our industry to come to the forefront in defense of honesty and excellence.

Let me warn those for whom laxity and "Ay bendito" are paramount that there is no room for them in this industry.

As president of the Puerto Rico League of Savings Institutions, I am personally committed to the maintenance of the highest standards of honesty, decency, and compliance in our industry.

I have personally instructed First Federal's operations director, as well as our compliance officer, to begin work in conjunction with their counterparts in all our member institutions on a series of industrywide seminars and workshops to address solely the issue of compliance, which we expect to hold on a continuing basis for the benefit of each and every individual institution.

The seminars will not only allow more uniform guidance in compliance but also serve as the basis for an industrywide compliance and operations manual.

The sum total of all of these efforts is to provide our member institutions with the necessary tools and expertise to be ever so vigilant, ever so prepared so as to insure that events like the ones witnessed last June 6 will never occur again. Thank you.

Chairman ROTH. Thank you. I want to, again, congratulate you for the leadership you are providing in this critical area. I must say I strongly approve and support the seminars you are having. It seems to me that is the most important way of reaching all financial institutions within your bailiwick. I would hope that that would be a continuing process because we find too often people become concerned for 1 year or 2 and then get diverted to other matters, and then, again, we find the same problems springing up.

As you know, we had hearings earlier this year which involved financial institutions in Boston which made considerable headlines in the media, and I thought would bring a message home loud and clear to all financial institutions wherever they may be.

Do you think the message is getting across today? What can we do to make people understand, I guess including the Government agencies, that we are dead serious about this matter?

Mr. MIER. I think the message is coming very clearly across.

Mr. LEDESMA. May I disagree a little bit?

Chairman ROTH. Sure.

Mr. LEDESMA. I think it is a matter of awareness. What was done in Puerto Rico has obviously created awareness. However, there are less painful ways of creating awareness, and this is going directly to the people that make the decisions. I think that the banking trade organizations in the United States have a great responsibility toward correcting some of these problems.

Within their programs, they have all types of training offered. We should go back and evaluate those trainings—for example, the compliance school is turning out compliance officers. Every year there is a graduating class. From the technical side of the business, the programming side, I think there has to be a greater involvement on the part of the technicians to understand that complying with this law is of paramount importance. For example, in our bank, we have already set up an information tally that at the end of the day we know all transactions at each branch over $10,000. The manager cannot be expected to know everything that goes on, especially in a very large branch, but by going through a summary of the transactions and with automation the way it is, is an easier task. I'm a very basic person. I started in the bank as a messenger 38 years ago, and some of the problems is that sometimes you have to go to the very basic areas.

First, do we understand the law? Can the law be simplified to be more effective? No. 2, is the operations area of the bank in harmony with the compliance area? If the two work together, we will have a much better system.

If there is lack of communication between the compliance and the people running the bank, you are bound to get into some trouble areas.

So I concur with Mr. Mier in general terms. The message has gotten across, but there would be less painful and damaging ways to do it on an ongoing basis, and we offer our wholehearted support to continue that involvement, to work with you as long as we have to, whenever you are dealing with revisions or changes in the law because I think that we have shown to you here today that we want to comply with the law, that we will not do business in our banks that is not in compliance with the law.

Chairman ROTH. I might say, as a matter of fact, after our earlier hearings, we wrote a number of major institutions, including the ABA. I will have to also say that I am not so sure that a letter always has the desired effect. But in any event, I am concerned that even today with all the publicity given not only in Puerto Rico but, as I mentioned, banks in Massachusetts and elsewhere, whether or not it is being taken seriously by all the financial institutions.

Of course, under our law, as you know, and I think you really have no choice, every institution is responsible itself for complying. It can't wait until it is put on notice. I think that is fundamental to our legal system and has to be understood by our institutions.

I want to, again, say that I appreciate what you two have been doing and the leadership that you are showing. I thought your one suggestion earlier about FDIC where they separated the enforcement, regulatory from the solvency from the other problems makes a great deal of sense, and we certainly shall consider that as well as both of you gentlemen's recommendations.

You may have heard me ask about bearer certificates. Is it true that a principal reason for them has been tax avoidance?

Mr. MIER. Senator, I believe that is the impression that most of the people in Puerto Rico have, as the Governor mentioned. The Secretary of the Treasury in Puerto Rico 2 weeks ago in our convention also mentioned he believed that most of the bearer certificates were used for tax evasion.

Chairman ROTH. Is there any good reason for continuing bearer certificates? Would that help end the problem?

Mr. MIER. If I may comment, Mr. Senator, the bearer certificate of deposit was created as a negotiable form for the secondary market in order for the banking system to obtain funds from the market. I think it serves a very good function in that area. Maybe some changes could be made, but I think as a legal negotiable instrument, it serves a very important purpose for the banks to be able to obtain funds and money.

Chairman **Roth**. Would you care to comment?

Mr. **Ledesma**. If I may just add a few comments. I think this was an evolution of the market, as such. However, again, just to go back to basics, there is no problem with a bearer certificate with the right information, the disclosure and the reporting to the Government. To me the most important thing is to be sure that whenever these instruments are generated, you have all the facts. The law is very clear as to deviations from that policy.

So to me, the only explanation is that whenever the information is not correctly stated, it is either a problem of lack of knowledge as to how to go about doing this, but let's remember that most of these large amounts are handled by people that have experience.

No. 2, I think that the reporting in the case of Puerto Rico should give the Government enough information to follow up on the amount of interest that has been paid. So I would not really be in favor of doing away with an instrument that has its role, but really the enforcement of the regulations that go together with the issuance of that instrument is really what has to be tightened up.

Chairman **Roth**. That may be correct, but what concerns me is the enforcement of those regulations, recent events have shown, are extraordinarily difficult. I suppose they do at least invite abuse and misuse. The problem I have is Congress is constantly setting up new regulatory agencies, as you look down the last 30, 40 years, only to find that somewhere down the way, time and again the regulations are not being adequately enforced and failing in their mission.

I have to say you are right in the sense if you can enforce the regulations, fine. But you almost sometimes have to have an army to do so.

I must say what I particularly respected in the comments of both of you is the fact that the enforcement internally has to come from the top down. It is the chief executive, whatever this title may be, that sets the tone for the banking or financial or any institution. It always bothers me and I understand even with strong enforcement procedures that there will be violations, people will not comply, and those things occasionally will go undetected for a period of time. But what has concerned me in a number of the cases here, as I said before, the people are sort of playing Pontius Pilate; they are standing above and pretending it doesn't exist. And that cannot be tolerated.

I have no further questions.

Mr. **Ledesma**. Mr. Chairman, I have one correction to make in our written statement. We made a slight mistake about the foundation of our bank. We stated that we were founded in 1983 and it should be 1893.

Chairman **Roth**. That makes some difference. [Laughter.]

Mr. **Mier**. Mr. Chairman, I ask my full report be included as part of the record.

Mr. **Ledesma**. Yes.

Chairman **Roth**. Yes.

Mr. **Ledesma**. And we will be supplying additional information regarding some of the areas that I think needs some clarification.

Chairman **Roth**. Any further suggestions you gentlemen might have from time to time, we will be glad to accept.

[The prepared statements of Messrs. Ledesma, with an attachment, and Mier, with an attachment, follow. Other attachments submitted for the record may be found in the subcommittee files.]

PUERTO RICO BANKERS ASSOCIATION
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STATEMENT OF HECTOR LEDESMA, PRESIDENT OF BANCO POPULAR DE PUERTO RICO, IN HIS CAPACITY AS PRESIDENT OF THE PUERTO RICO BANKERS ASSOCIATION BEFORE THE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS.

JULY 25, 1985

Mr. Chairman, Members of the Subcommittee, my name is Hector Ledesma, and I am the President of the Puerto Rico Bankers Association and President of Banco Popular de Puerto Rico.

I appreciate the opportunity to appear before this Subcommittee. In my statement, I will briefly describe the composition of the banking industry in Puerto Rico, the regulatory requirements that affect the banking industry there, and our efforts to comply with all applicable statutes and regulations.

Before discussing the compliance by the members of our association with the Bank Secrecy Act and its related regulations, I would like to provide the Subcommittee with some background on the commercial banking industry in Puerto Rico. This industry includes some of the most important banks in the world. Several of the largest banks in the United States are included among its members. Canada is represented by two of its most prominent banks and three large Spanish banking concerns own locally chartered institutions. Four of these local banks are large enough to have been listed among the three hundred largest commercial banks by assets in the United States as of December 31, 1983. (Banco Popular, 96; Banco de Ponce, 171; Banco Central Corp., 221; Banco de Santander, 271). (For details, see Table I).

The eighteen commercial banks in Puerto Rico operate a total of 298 banking units throughout Puerto Rico. Five of these eighteen commercial banks are national banks including, Citibank (since 1917), The Chase Manhattan Bank (since 1934), Bank of America (since 1978), Continental Illinois (since 1980) and First National Bank of Boston (since 1982). These banks operate 36 units with total assets of $7.558 billion as of April 30, 1985. In addition, the two Canadian banks in Puerto Rico, The Royal Bank of Canada (since 1907) and the Bank of Nova Scotia (since 1910), operate six banking units and had total assets of $797.6 million as of April 30, 1985. The Canadian banks also each own a locally chartered commercial bank (The Royal Bank de Puerto Rico, Inc. and Scotiabank de

Puerto Rico) that together operate an additional 25 banking units with $851.3 million in assets. (For details, see Table I).

The remaining nine commercial banks are locally chartered commercial banks, including Banco Popular de Puerto Rico, Banco de Ponce, Roig Commercial Bank, Banco Financiero, Banco de Caguas, Banco Cooperativo, Banco Central Corp., Banco de Santander and Banco Commercial de Mayaguez. These banks operate 234 banking units with total assets of $7.957 billion as of April 30, 1985.

In addition to these commercial banks, there are several trust companies with banking powers operating in Puerto Rico each of which has a single branch: Espanola de Finanzas Trust Company, Las Americas Trust Company and Universal Trust Company, which together had total assets of $40.2 million as of April 30, 1985. Altogether, as of April 30, 1985, the banking industry in Puerto Rico had $17.205 billion in total assets.

These banks doing business in Puerto Rico have to comply with both federal and local banking regulations. They are regularly examined by regulatory agencies of both governments and any violations or deficiencies discovered in bank operations are corrected with due diligence.

Specifically, the banking industry in Puerto Rico is supervised by the following regulatory agencies: the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System. The banks are also supervised by the Secretary of the Treasury of the Commonwealth of Puerto Rico, and with regards to certain credit transactions, by the Secretary of the Department of Consumer Affairs. The Secretary of the Treasury of Puerto Rico examines all locally chartered banks, trust companies and the Canadian banks. The Federal Deposit Insurance Corporation examines all the locally insured banks, other than Banco Cooperativo, which is not insured by the FDIC. The Office of the Comptroller of the Currency examines branches of the national banks organized in Puerto Rico and the Federal Reserve Board System examines the state member banks. Furthermore, the Secretary of the Department of Consumer Affairs regulates all the banks in matters pertaining to credit card and installment sales.

Now, I would like to address the main reason for my appearance today which is to illustrate compliance efforts by the members of our Association and in particular by Banco Popular de Puerto Rico with the provisions of the Bank Secrecy Act and its related regulations. The Act was designed to facilitate government investigations of bank customers through well kept records regarding certain financial transactions.

The banking industry in Puerto Rico has made every effort to comply fully with all regulations including the Bank Secrecy Act. Title I of the Act deals with the retention of records by federally insured banks and federally insured savings and loan associations. We are aware that these records which are required to be filed and maintained are very useful in ongoing investigations and prosecutions involving areas such as organized crime, narcotics, tax evasion and public corruption. Since 1950, in compliance with Section 34 of the Banking Law of Puerto Rico, the banks have been maintaining records similar to the ones required by Title I. This Section requires that such records must be retained for a period of 10 years, which is even longer than the six-year retention requirement under Title I (Financial Recordkeeping) of the Bank Secrecy Act. Following the enactment of the Bank Secrecy Act, banks in Puerto Rico only needed to add the identification of "individuals" making transactions reportable under Title II of the Act, in order to comply with the additional recordkeeping requirements prescribed by Title I.

Title II (Reports of Currency and Foreign Transactions) of the Bank Secrecy Act regulates records and reports on monetary instrument transactions. This Title requires that an entirely new set of internal controls and records be kept by "financial institutions" as this term is broadly defined by the Act.

On July 23, 1974, the Governor of the Commonwealth of Puerto Rico signed into law Act No. 131 titled "Act to Regulate Transfers of Funds to Foreign Countries." This law requires that a complete set of records be kept of every transfer of funds by a banking institution to or from a foreign country which exceeds $5,000.00. The law requires that the records include the name, address, taxpayer or social security number of every person involved in the operation, the interrelationships of all those involved in the transactions, the legal capacity of any person that intervenes in the transaction and a complete description of the transaction itself. Banks in Puerto Rico report those transactions to the Secretary of the Treasury of the Commonwealth of Puerto Rico on a form similar to the currency transaction report of the Internal Revenue Service (Form 4789).

Let me give you an overview of compliance efforts by members of the Puerto Rico Bankers Association. The complex network of laws and regulations affecting the banking industry has made it necessary for banks to formalize the procedures and practices in order to satisfy these requirements. Prior to 1978, the federal regulatory agencies included a report of compliance with the Bank Secrecy Act as part of their overall examination report. However, since 1978, they have prepared a separate compliance examination report which, among other things, includes compliance with the Bank Secrecy Act. These changes demostrated that the agencies placed a higher priority on the regulatory functions relating to the statutes and regulations that they supervised. In response, the members of the Puerto Rico Bankers Association have instituted a number of new policies and procedures.

We are well aware that establishment of an overall policy and procedure program is the best safeguard to ensure against violations of these laws. The wide scope of these requirements make it necessary that both bank directors and senior management have an understanding of this area and that their involvement in ensuring compliance is essential. The success of a compliance program in any banking institution depends greatly on the priority that it receives from both the Board of Directors and senior management.

In Puerto Rico, commercial banks of all sizes have appointed Compliance Officers who are responsible for establishing and maintaining individual compliance programs.

Some larger institutions have full time Compliance Officers while other smaller institutions have part time Compliance Officers.

A major part of the compliance program by banks in Puerto Rico is dedicated to the training of bank personnel. New employees receive orientation on compliance matters as a integral part of their training. In addition, continuing compliance education for bank personnel is also provided through seminars.

Furthermore, internal audit procedures, similar to those used in the examination procedures of federal agencies are used to monitor compliance and detect any potential weaknesses or violations. The findings of these audits are reported to the Board of Directors and often include suggested corrective action. Part of the responsibilities of a bank's Compliance Officer is to verify that any exceptions noted have been corrected. This procedure is also followed with respect to the compliance examination reports filed by the appropriate federal agencies. Finally, the Compliance Officer also consults legal counsel regarding any legal issues which may arise in connection with compliance.

In order to give the Subcommittee a better understanding of these compliance procedures in Puerto Rico, I would like to use the example of our procedures in the Banco Popular de Puerto Rico, the bank of which I am President. Our bank, which was established in 1983, comprises 114 branches in Puerto Rico, three in the U.S. Virgin Islands, seven in New York, one in Los Angeles, and one in Chicago. Because of the size of our bank, an attorney was appointed as a full time General Compliance Officer. This officer attended the National Compliance School at the University of Oklahoma in March 1980 and the National Compliance School at the same university in October 1983. Both of these schools are sponsored by the American Bankers Association. The Compliance Office is presently staffed by eleven employees and they are recognized throughout the Bank as the authority on compliance matters. Bank personnel at all levels are encouraged to contact this office and know that thev will receive full assistance.

The compliance program which was established provides the framework of the bank's procedures and serves as a reference guide for all bank personnel. Since the beginning, I personally have been committed to this program and it has received my full endorsement and cooperation. Compliance manuals were prepared for branches, departments and the Auditing Division. The Auditing Division Policy and Procedures

Manual includes check-lists which are used during the compliance examination process. These manuals are constantly updated to include any changes or new regulations.

We have also assigned compliance liaisons in various areas of the bank including all departments and branches. Our branches in Puerto Rico are grouped by District Offices. There are actually eleven such offices with anywhere between eight to 13 branches assigned to each one. At each District Office, one person is assigned as compliance liaison who is responsible for all compliance matters. At the branch level, the assistant managers assume this same responsibility.

The operating instructions pertaining to regulatory requirements are reviewed by the General Compliance Officer before final editing and distribution to all the corresponding bank areas. These written instructions and policies are also kept in binders for ready reference by bank personnel. Since the effective date of the Bank Secrecy Act, specific instructions have been prepared and have also been revised frequently to implement operational controls, as well as regulatory changes. We have available for your review the instructions regarding this regulation which have been distributed in Banco Popular since 1972.

The training of bank employees of Banco Popular in compliance matters has always been an important aspect of the Compliance Program at our institution. This training is given at all levels and includes all pertinent laws and regulations. The requirements of the Bank Secrecy Act are included as part of the new tellers training program and is also extended to all other branch employees. An update of current requirements, as well as refreshers of long-standing requirements, are also included as part of this ongoing training. Such training helps to assure that bank policies are being followed as required.

Various training tools are also used including models of the currency transaction reports (CTR) and full training on the correct manner for completing them. As part of this training, the bank uses the Supplemental Instructions for Completing Form 4789 supplied to us by the U.S. Department of Treasury. The issuance of a monthly Compliance Bulletin by the Compliance Office began in January, 1982 covering all the regulations, although special emphasis is given to the Bank Secrecy Act. The December 1983 issue of this bulletin is a Spanish translation of the U.S. Department of the Treasury Supplemental Instruction mentioned above. Other issues include topics such as how to prepare the exempt customers lists and the recent fines to U.S. banks for violations of the Bank Secrecy Act.

The reporting of currency transactions is operationally handled in the following matter:

1. The Officer that processes the transaction is responsible for preparing the CTR. If a teller directly receives the currency transaction, he must refer the customer to the branch operations officer who is then responsible for the preparation of the CTR.

2. Reports (CTR) prepared by other officers are also turned in to the branch operations officer.

3. At the end of the business day, a computer printout of all currency transactions exceeding $10,000 is prepared and the branch operations officer uses it to verify that a CTR has been prepared for each of these transactions, unless a customer is on the exempt customers list.

4. An original and two copies of each report are then sent to the General Compliance Officer on the same day of the transaction.

5. At the Compliance Office, the original form is then mailed to the Internal Revenue Service at Ogden, Utah and one copy is returned to the branch stamped by the Compliance Office.

6. During the internal audit examinations, the examiners verify that all the CTRs on file at the branch have been stamped as received by the Compliance Office.

In many instances, transactions have been reported which appeared suspicious in nature even when the amount involved did not exceed $10,000. Transactions under $10,000 which are spread over a few days have also been reported in cases where the Officer perceives that such transactions could be a pattern used to circumvent the reporting requirements. In these cases, the reporting Officer encloses an explanatory memorandum setting forth the reasons for the basis of his suspicion.

Our exempt customers lists are revised by the branch managers twice a year for each semester ending June 30 and December 31. This is done in order to add new accounts, eliminate closed accounts, etc. Between revision periods addendums to the original list may be prepared as the need arises. These lists are sent to the General Compliance Officer for approval, together with a memorandum indicating when the account was established, the type of business, the average balances for one month and six months, and a brief explanation as to why the customer is being placed on the list. This means that managers must make a background check before placing a customer on this list. Once verified and approved by the General Compliance Officer, a copy is returned to the branch for its records. All the original lists are kept in a centralized file for a period of five years, as required by regulations.

Any request to the U.S. Department of the Treasury for a special exemption must be processed by the Compliance Office. The approval letters received from this Department are also kept on file at this office. I want to mention that we have always received the utmost cooperation of the U.S. Department of the Treasury in connection with this regulation whenever additional information or clarification has been necessary.

Since 1979 Banco Popular has been examined on compliance by the Federal Deposit Insurance Corporation on five occasions. The Bank Secrecy Act related to three of these examinations. No substantive violations were found in any of these examinations.

In August 1983, the bank received a letter from Mr. Robert E. Powis of the Department of the Treasury, requesting our exempt customer list. This list was provided to the Treasury within the 30 day time limit required by the regulation. These lists were verified by the agency and no violations were cited. Only minor corrections were made, such as substituting postal address for street address. I would like to point out that although the findings of these agencies are important, our monitoring depends chiefly on our own internal audits and control processes.

On January 11, 1983, Banco Popular held a seminar on the Bank Secrecy Act which was attended by all branch managers and executive officers. The speakers included Everett De Jesus, Esq., from the Department of Justice, and Rafael Rivera Rodriguez, a special agent from U.S. Customs. Similar meetings and conferences sponsored by the Puerto Rico Bankers Association were also held at this time. As a result of these seminars regarding Operation Greenback, compliance efforts were intensified. Even though compliance with the requirements of the Bank Secrecy Act had received top priority in the Puerto Rican banking industry since the Act became effective, the warning received concerning Operation Greenback raised additional awareness of the need for more rigorous controls.

The banking industry in Puerto Rico has always assigned a high priority to matters related to compliance with the applicable laws and regulations. In addition, since 1982, the industry has continued to intensify its efforts to comply with Title 31. This effort has become so pronounced that compliance has become a field in itself although it is costly and involves a great amount of work on the part of the banking institutions. As I explained above, special emphasis has been given to the requirements of the Bank Secrecy Act since it became effective during the 1970's. The recent events regarding violations to this Act by various banks in the United States has provoked an even higher degree of awareness in Puerto Rico.

The Bankers Association of Puerto Rico has always fully supported efforts by federal agencies to enforce all applicable statutes and regulations. Mr. Chairman, I assure you that this association will redouble these efforts in the future.

I trust that this brief summary of the compliance efforts of the members of the Puerto Rico Bankers Association in general and Banco Popular de Puerto Rico in particular demonstrates the concern given to problem by our industry. We have in the past, and will continue in the future, to recognize the critical importance of ensuring compliance with all banking regulations.

TABLE I

SELECTED DATA ON THE BANKING INDUSTRY OF PUERTO RICO
AS OF APRIL 30, 1985
DOLLAR FIGURES IN MILLIONS

	Total Assets	Total Deposits	Total Loans(1)	Number of Units (2)
Puerto Rico Chartered Banks (3)				
Puerto Rican Ownership				
Banco Popular de P. R.	$3289.3	$2817.9	$1334.9(2)	114
Banco de Ponce	1715.9	1410.3	756.8(4)	42
Banco de Santander-P.R.	1078.5	990.3	408.8(5)	23
Banco Central Corp.	1029.5	768.6	303.5(6)	22
Royal Bank de P. R., Inc.	427.6	357.1	195.7(9)	17
Scotiabank de P. R.	423.7	356.8	159.2(10)	8
Banco Comercial de Mayaguez	360.8	289.0	103.3(11)	9
Roig Commercial Bank	297.8	185.6	121.9(12)	11
Banco Financiero	150.7	110.1	84.3(15)	6
Banco de Caguas	35.4	31.1	17.9(18)	3
Sub-Total	8809.2	7316.8	3486.3	255
National Bank's Branches				
Citibank	3912.6	3641.4	1984.0(1)	21
Chase Manhattan Bank	2611.6	2550.1	1728.1(3)	11
Bank of America	694.4	624.0	246.8(7)	1
First National Bank of Boston	229.4	232.2	153.5(13)	2
Continental Illinois	110.3	74.0	62.3(16)	1
Sub-Total	7558.3	7121.7	4174.7	36
Canadian Chartered Banks				
Royal Bank of Canada	573.5	515.1	339.5(8)	5
Bank of Nova Scotia	224.1	158.1	85.2(14)	1
Sub-Total	797.6	673.2	424.7	6
Trust Companies (4)				
Las Americas Trust Co.	36.0	31.4	23.9(17)	1
Española de Finanzas Trust Co.	2.4	.7	1.0(19)	1
Universal Trust Co.	1.8	0	1.3(20)	1
Sub-Total	40.2	32.1	26.2	3
TOTAL	17,205.3	15,143.8	8,111.9	300

(1) Ranking by total assets

(2) As of June 30, 1985, includes all authorized branches.

(3) No data was available for Banco Cooperativo.

(4) With commercial banking powers.

TESTIMONY
PRESENTED BY
MARIANO J. MIER,
PRESIDENT
AND CHIEF EXECUTIVE OFFICER
FIRST FEDERAL SAVINGS BANK
OF PUERTO RICO
IN HIS CAPACITY AS
PRESIDENT
OF THE
PUERTO RICO LEAGUE
OF SAVINGS INSTITUTIONS
ON THE ISSUE OF
DOMESTIC MONEY LAUNDERING
BEFORE THE
PERMANENT SUBCOMMITTEE
ON INVESTIGATIONS
OF THE
COMMITTEE ON
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE
NINETY-NINTH CONGRESS
FIRST SESSION
JULY 25, 1985

Mr. Chairman, Members of the subcommittee, my name is Mariano J. Mier. I am President and Chief Executive Officer of First Federal Savings Bank of Puerto Rico. In addition, I am president of the Puerto Rico League of Savings Institutions, and it is in this capacity that I appear before you today.

The savings and loan industry on the island consists of twelve institutions, operating under the provisions of the Home Owners' Loan Act of 1933. They have combined assets totaling 4.5 billion dollars, of which 48.8 per cent or 2.2 billion dollars are concentrated in two institutions--First Federal Savings Bank and Caguas Federal

Savings Bank.

In the past few years the industry has been seriously affected by the same factors that created havoc on the mainland--rampant inflation, record high interest costs for liabilities, and fixed, long-term, low return assets.

As a result of deregulation, the curtailment of inflation and the changes that such an environment wrought on our institutions, the industry has been able to significantly alter its failing health.

In 1984, after many years of depressed results, the thrift industry in Puerto Rico was able to show a combined net profit of 16.3 million dollars, a performance that, based on partial results to date, will be far surpassed in 1985.

The changes that deregulation and new powers have brought about in our industry, altering traditional conduct patterns and injecting new and better ways of managing our business, have definitely left an imprint in our institutions.

We no longer depend solely, even though it still represents the bulk of our business, on the construction and housing industries--to which we still devote more than fifty per cent of our total combined assets.

As a result of deregulation, we are now more active in pursuing assets that have traditionally been associated with other financial institutions. In this pursuit we have changed the profile of our business by devoting our resources to a more diversified asset structure and marketing style that has made our industry virtually indistinguishable from our commercial banking cousins.

All these changes are not only evident in our ledgers. The human profile of the industry is also rapidly changing with more and more commercial bankers finding themselves in new roles as thrift executives.

In short, today, the savings and loan establishment, largely due to Congressional actions, only vaguely resembles the industry that was created, more than half a century ago, in order to enable the citizens of America to finance their homes.

The same holds true

in Puerto Rico, an island that is separated from the mainland United States by thousands of miles of ocean, but that is bridged by similar customs, mores, and rules of conduct.

The same problems and opportunities that financial institutions face on the mainland are faced by our local financiers. We are no different from our mainland counterparts.

We are regulated and supervised by the same regulators and supervisors--in our case the Federal Home Loan Bank and the Federal Savings and Loan Insurance Corporation--as are our fellow thrifters in Florida, Georgia, Delaware, or Alaska.

Therefore, we are prone to face the same challenges that the financial community faces throughout the United States.

We, thus, benefit from the same benefits that the mainland financial community enjoys and are affected by the same problems they endure.

Nonetheless, the events of last June 6th, have significantly altered the image of an industry that until that date had not been suspect of wrongdoing, least of all of collaboration with organized crime.

On that unmemorable date Federal law enforcement agents arrested in Puerto Rico fourteen financial institution employees, including a bank president, on charges of conspiring to illegally launder money, most of which allegedly is derived from drug-related activities.

The disclosure of these actions, undertaken by an army of more than 200 agents, took everyone by surprise and have shamed the honest, law abiding Puerto Rican business community.

Even though I was aware of the undercover investigation that was underway and had been, as head of the island's oldest and largest thrift institution, in close collaboration with regulators and law enforcement officials, the first I heard of the June 6th raid was from the late Bryce Curry, president of the Federal Home Loan Bank of New York, who called my office minutes after our largest branch was intervened by Federal agents.

My initial reaction was one of shock at the magnitude of the operation which included, not only savings and loan institutions but also commercial banks.

I was also surprised that agents had raided our largest branch for I, personally, have been the most persistent and obsessive watchdog of compliance with all the laws and regulations which apply to our industry.

My initial surprise at the unexpected raid of our Plaza Las Amèricas branch changed drastically during the rest of the afternoon as more information became available regarding the scope of the actions.

First of all, the only reason Federal agents had entered our premises was to secure documents dealing with transactions that had been carried out in one account by a former employee of our institution, who was asked to resign more than a year prior to the events of June 6th as a result of his failure to adhere to our compliance and internal audit procedures.

In the Spring of 1984 this employee was placed on probation due to some operational deficiencies discovered in the course of an internal audit.

Subsequent to that action the employee called our compliance office to give his reasons for the late submittal of a currency transaction form. At the same time, the employee communicated to our Senior Vice President in charge of Operations to inform him about a currency transaction that he claimed, and I quote, "was suspicious."

Our operations director proceeded to meet with Special Agent Rafael Rivera of the United States Customs Service who informed our officer that the employee's assertions were false, that he was under surveillance and would be arrested.

Under the circumstances, in order not to compromise the Federal investigation underway, we asked for the employee's immediate resignation based on his prior operational deficiencies.

Almost a year later he was arrested by Federal agents and charged with violating the Bank Secrecy Act.

On June 6th, as my concerns for the prestige and well being of my own institution subsided, preoccupation for the effects of the day's actions not only on our thrift industry, but on our entire financial community, as well as on Puerto Rico, began to mount.

I felt saddened and shamed. I felt betrayed by those who had harbored clandestine motives, foreign to the laws and regulations, as well as to the best interests of our industry, and in doing so had dragged with them the trust and reputation of scores of honest and decent men and women that daily labour with great dedication and devotion for the good and well-being of our industry and of the people of Puerto Rico.

I felt no satisfaction from the knowledge that my institution, First

Federal Savings Bank, had survived the ordeal untarnished. I, after all, had been entrusted, just two months before, with the presidency of the Puerto Rico League of Savings Institutions, and had far greater responsibilities than those of my institution. I now was custodian of the trust, the welfare and well-being not just for First Federal Savings Bank, but for the entire industry.

The scandal, which was prominently displayed by both the local and national media, was unprecedented in Puerto Rico's history. Until that day the only precedents we had were those of similar violations found in a host of financial institutions in the mainland United States.

In my new position as

president of the Puerto Rico League of Savings Institutions, a post almost as new as my initiation as a thrifter, for prior to December 1982 I had been a commercial banker for almost all my professional life, it was of paramount importance to leave aside competitive considerations and address the problem from the vantage point of how to stop whatever erosion in the people's confidence in our industry had resulted from the arrests.

On June 13th, after chairing a board meeting of our League, in a prepared statement released to the local media, I reaffirmed, as I had done following the arrests of June 6th, our full cooperation with the continuing federal investigation and welcomed the opportunity to get rid of any unscrupulous member of our financial community found in violation of the law and/or the regulations.

At the same time, I offered my fellow thrifters the services of our own compliance officer at First Federal Savings Bank, who personally headed an in-depth compliance seminar for all member institutions last June 22nd.

As I cannot be fully conversant about the compliance procedures that have been followed or that are now being followed by all the thrift institutions on the island and since my participation in this industry is of recent vintage I beg that you allow me to share with you the experiences that I have had at First Federal Savings Bank with matters of compliance. After spending almost my entire professional career in commercial banking I joined First Federal Savings Bank in December of 1982.

At that time, the bank had amassed a net combined loss in excess of 58 million dollars in just three years, forcing the Federal Home Loan Bank to intervene and save the bank by injecting much needed capital into the hence referred to "Phoenix" institution.

It was obvious from the beginning that the institution, with total assets of 1.2 billion dollars and 22 branch offices, was in dire need of a complete overhaul, not only of its systems, but also of its administrative culture. Changes were made. New faces were brought in. Systems were updated. As a result, the bank has turned around dramatically, showing net profits for the last thirty months and is well on its way to recovery. Yet the overhaul we began in 1983 continues.

One area to which I personally devoted special attention, for it is an area that I feel should be addressed to by the chief executive officer, was the matter of compliance with all the laws and regulations.

A compliance officer with extensive commercial compliance banking experience was hired.

A compliance office was created and has subsequently been revamped and expanded. All compliance procedures, manuals and trainings were examined and restructured.

Our records show that the institution's compliance guidelines for currency transactions promulgated in 1972 (see Exhibit A, herein attached) had been first revised, ten years later, in 1982 (see Exhibit B, herein attached).

We reviewed the guidelines and issued a revised operations manual in August of 1983. This new set of guidelines was subsequently expanded and revised in October of 1984 (see Exhibit C, herein attached) and is constantly under review.

The Secretary of the Treasury requires that any and all deposits, withdrawals, exchanges of currency, or other payments or transfers which involves a transaction in currency of more than ten thousand dollars be reported to the Internal Revenue Service by filing Form 4789 within fifteen days of the transaction.

At First Federal we file our Form 4789 reports each week.

In addition, all branch transactions requiring the filing of Form 4789 must be submitted to our central compliance office within three days of the date of the transaction for auditing and review, so as to double check close adherence with the intent and the spirit of the law.

The Federal regulations, nonetheless, establish an exemption to this rule in cases that basically involve retail establishments which handle large sums of currency. While some of our clients fall under this classification, their exempt status petition filed by our branch managers is revised by our Central Compliance Office and, if found unjustified, is immediately overuled and forced to conform to the standard currency reporting obligations.

In addition, branch wide exempt lists are revised by our compliance officer every semester.

In March of this year we also started a branch by branch record of any and all telephone conversations or consultations made with our Central Compliance Office regarding the filing of Form 4789.

As an additional control, the Audit Division has been entrusted with the branch by branch audit of Form 4789, which is conducted during the review of teller transactions.

The Audit Division is charged, also, with the responsibility of constantly examining the working funds of each branch operation in order to determine, at any given time, whether an unusual amount of cash is requested or reported by each audited unit.

Violations of these operational guidelines are not only frowned upon but acted upon immediately as can be confirmed by our personnel records.

Another important aspect of our compliance (see Exhibit D, herein attached) efforts involves the continuous training of our personnel, from senior executives to branch managers to tellers.

Since April of 1984 we have held six different compliance seminars for our bank's employees. In addition, new recruits have to go through a cash transaction compliance seminar that is not elective but compulsory for all employees regardless of position or experience.

Another problem we are in the process of correcting is the absence of adequate software in the bank's electronic data system that will enable us to track down and profile cash transactions. All deposits and withdrawals, without exception, appear as cash transactions whether or not they are cash based.

In order to correct this situation and allow us to have a better centralized control of transactions a new mainframe computer and software have been purchased to replace our old thrift operations software. This new system, which will be partially operational by the end of this year and fully operational by 1986, will provide a true portrayal of transactions and augment our enforcement and compliance capabilities.

No system is perfect or infallible. That is why we all have the responsibility to be vigilant at all times and least of all to fall into complacency or neglect.

Less than two weeks ago, on the 12th of July, I was elected to my first full term as president of the Puerto Rico League of Savings Institutions and in my acceptance speech stressed the need for stronger compliance with the laws and regulations of our industry.

I would like to quote

to you briefly from those remarks:

"Bryce Curry was a true friend of Puerto Rico and the Puerto Ricans. Because of him we can proclaim the rehabilitation of an industry that without his help would have gone under.

We will definitely miss Bryce.

Yet, we cannot miss those who violated our trust and confidence and embarked on personal adventures foreign to the best interests of our industry.

That is right now our biggest task: to look inward, not in an unproductive and narcissistic fashion, but with a sense of commitment towards the utmost care in strengthening our compliance and respect for the industry's standards and regulations.

There cannot be any deviation from the norm. This task, contrary to what some might profess, is not a task for regulators, it is a task for all of us in this room.

I am personally committed, as I have always been, to the upholding of the Law and the regulations of our industry.

This is not a time for laxity. This is not a time for "Ay bendito". This is a time for all the honest and hard working men and women in our industry to come to the forefront in defense of honesty and excellence.

Let me warn those for whom laxity and "Ay bendito" are paramount that there is no room for them in this industry". End quote.

As president of the Puerto Rico League of Savings Institutions I am personally committed to the maintenance of the highest standards of honesty, decency and compliance in our industry.

I have personally instructed First Federal's operations director, as well as, our compliance officer to begin work in conjunction with their counterparts in all our member institutions on a series of industry wide seminars and workshops to address solely the issue of compliance, which we expect to hold on a continuing basis for the benefit of each and every individual institution.

The seminars will not only allow more uniform guidance in compliance but also serve as the basis for an industry wide compliance and operations manual.

The sum total of all of these efforts is to provide our member institutions with the necessary tools and expertise to be ever so vigilant, ever so prepared so as to insure that events like the ones witnessed last June 6th will never occur again.

Thank you very much.

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FIRST FEDERAL SAVINGS BANK

Internal Controls to Insure Compliance with the Bank Secrecy Act Regulations 31 CFR103.11 et. seq.

I. Introduction

To insure compliance with the U.S. Treasury Department's Record Keeping and Reporting requirements, First Federal Savings Bank of Puerto Rico has undertaken the following:

a) Centralize in the Compliance Officer all the responsibility for complying with the regulations;

b) Develop an on-going intensive training program for First Federal's employees at all levels;

c) Audit systematically by the Internal Audit Division to verify compliance with the law, and;

d) Cooperate fully with Federal authorities investigating any financial recordkeeping problems.

II. Centralization of the compliance function within the Institution

Two and a half years ago First Federal established the Compliance Office. During the course of these years the Office has been expanded from two persons to four composed of the following: a Compliance Officer who is an attorney-at-law, a Compliance Technician who is also an attorney-at-law, an Equal Employment Opportunity Officer who also serves as a Compliance Technician and a secretary.

First Federal is intent on satisfying all Financial Recordkeeping requirements. In 1983 the Compliance Office prepared a detailed Operations Manual which has been twice updated and expanded. Prior to 1983, there existed only general instructions to which only two revisions were made in an eleven year period.

Essentially our Manual requires that for any cash transactions of $10,000.00 or more, a form (4789) must be submitted to the Compliance Office within three labor days. In addition, our branch personnel have been constantly instructed to also submit a form (4789) for any transaction which, in their opinion, appears strange regardless of whether or not it is a cash transaction or a cash transaction of less than $10,000.00. For example: a customer wants to withdraw a sum of money over $10,000.00 but wants to do it in small checks payable to different persons. Our policy requires that a CTR be filed even though no cash transaction as been effectuated.

Once the form is filed with the Compliance Office a record is made setting forth the name of the branch, date received, date of the transaction, customer's name, customer's social security number, amount of the transaction, whether the form is correctly prepared or not, if not correct, when was the form returned to the branch, date when the branch returned the corrected form and the date that the form was sent to the IRS. When the form arrives at the Compliance Office, it is thoroughly reviewed by one of the staff members. If not correct, the form is sent back to the branch with a two day deadline for preparing a correct one. Every Friday a letter is prepared and sent to the IRS enclosing the forms processed during the week. There is ample coordination between the Compliance Office and the Audit and Branch Administration Divisions. Any deviation from this policy and procedure requires that the Branch Manager submit a written report explaining said deviation. The Compliance Office then decides if it should follow through with an investigation. An example of this would be if a branch employee submits a form within a 10 day period and not the three day one as required. This in itself is a deviation of internal procedures. For the first and second violation a telephone call is made to the branch.

If the violations persist, then a full report is made to the Branch Administration Division and the Audit Division. If the violation is of a more serious matter, for example, negligence in filing the form, a full report is made to the Audit Division and a report is submitted to the top management. Sanctions may range from a severe reprimand to dismissal. First Federal has been very strict in enforcing this policy.

First Federal's procedures for maintaining the exempt customers list are very stringent. The detailed instructions provide clear guidelines as to who may and who shall not be exempted. A form has been prepared for this purpose. Each branch manager has to submit a copy of that branch's exempt customer list to the Compliance Office where it is reviewed promptly. Whenever there is a doubt regarding the eligibility of any person, a written report is required from the manager in order to justify the exemption. The Compliance Office then determines the validity of the justification. The Office has full authority to overrule any branch manager with regard to any exemption given. All exempt lists must be reviewed every six months.

The Compliance Office maintains a complete file for each branch and since March, 1985, a record is kept per branch of every incoming or outgoing telephone call regarding a compliance matter. The Office also serves as a back-up center for every branch and resolves doubts or provides answers to questions regarding form 4789. A record is kept of every consultation made, whether in writing or by phone.

Since February 1985, a monthly report is prepared specifying the number of CTR forms prepared by each branch. This report is sent to the Branch Administration Division and to the Audit Division.

All of the above enables us to determine whether a particular problem exists within a given branch and the corrective measures that may be required.

III. Training Program

First Federal, recognizing the importance of this law, has developed an intensive training program for all staff levels of our bank.

During 1983 and 1984, one training session per year was provided to all our branch managers. These training sessions were given by the U.S. Customs Service and IRS agents. In June and October 1984, training sessions were given by the Compliance Office to all our head tellers and other branch personnel. Starting in April 1985, and each month thereafter through September, training sessions have been and will be given to all our branch personnel. We have specifically incorporated into the training program of all our new tellers the requirements of Form 4789 and of other forms and requirements provided in the Bank Secrecy Act. Kindly note that all of this was done before Operation Tracer was begun in Puerto Rico. Additional training will be given during the coming years.

IV. Audit Division

The Audit Division has included as a part of its branch audits, the review of form 4789. During the review of the tellers transactions (spot checks), the deposit slips, withdrawals slips, checks and money order requests are examined. Also the tapes that are prepared by the tellers are checked to see if there was any cash transaction over $10,000.00 registered. If such a transaction is found, either a corresponding CTR must have been prepared and submitted or the specific customer must appear within the exempt list. The branch file on CTR's is compared with the equivalent file at the Compliance Office.

Depending on the violations found, the Bank then determines the action to take. As was stated before, this action ranges from a severe reprimand to dismissal plus a possible notification to Federal authorities.

A constant examination is done over the working funds of each branch in order to determine whether an unusual amount of cash is requested or reported by the branch. This is used as a way to detect possible problems. Once a branch reports receiving or requesting an unusual amount of cash, a check is made to see if the corresponding CTR's are filed or whether there was any justifiable reason for the report or request.

V. Cooperation with Federal Authorities

First Federal has extensively cooperated with the Federal authorities in regards to CTR monitoring. Whenever our internal audit procedures have revealed a serious violation, Federal authorities have been promptly notified. An example of this, was a case involving one of our former branch managers in operation Tracer. He had reported information regarding the transactions involved. When we contacted Federal authorities, we learned that the real story was different. But the fact remains that we acted promptly based on the information available to us. Because of additional operational problems, we asked for the manager's resignation.

First Federal has been, is and will be committed to full compliance with Federal laws and regulations. We are now taking steps to further ensure an even more strict compliance.

We are constantly reviewing our Operations Manual, preparing more in-depth training programs, and reviewing our internal audit procedures. Furthermore, a current revamping of our Electronic Data Processing System will permit us to receive information on any transaction that triggers CRT requirements on a daily basis.

First Federal has already provided support for the Puerto Rico Savings Institutions League in the form of a CTR seminar. Additional training seminars for its members will be recommended. The formation of a Compliance Committee will be suggested to the League that would not only create awareness regarding compliance, but would issue guidelines for all institutions. Training would be coordinated with the Federal authorities.

Chairman ROTH. The subcommittee is in recess.

[Whereupon, at 1:21 p.m., the subcommittee adjourned.]

[Present at time of adjournment: Senator Roth.]